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TRANSCRIPT OF RECORD

Supreme Court of the United States

OCTOBER TERM, 1932

No. 448

PETROLEUM EXPLORATION, PETITIONER,

vs.

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT

PETITION FOR CERTIORARI FILED OCTOBER 12, 1932

CERTIORARI GRANTED NOVEMBER 14, 1932

(37,145)

(37,145)

SUPREME COURT OF THE UNITED STATES

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DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT

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JUDD & DETWEILER (INC.), PRINTERS, WASHINGTON, D. C., DECEMBER 6, 1932

TRANSCRIPT OF RECORD

Docket No. 43480.

Petroleum Exploration
vs.
Commissioner of Int. Rev.

For Taxpayer: Leland E. Fiske, C. P. A.; T. J. Reilly, Esq.; Robert Ash, Esq.; For Commissioner: E. Meacham, Esq., C. E. Lowery, Esq.

DOCKET ENTRIES.

1929
Apr. 4—Petition received and filed. Taxpayer notified. (Fee paid.)
" 5—Copy of petition served on General Counsel.
May 27—Answer filed by G. C.
" 29—Copy of answer served on taxpayer—general calendar.
1930
Mar. 22—Notice of appearance of Robert Ash and T. J. Reilly as counsel for taxpayer filed.
June 6—Application for order to take depositions filed by taxpayer.
" 9—Motion to withdraw application to take depositions filed by taxpayer. 6-12-30 Granted.
June 10—Objection to issuance of order to take depositions filed by G. C.
Sept. 12—Motion to consolidate with dkt. 49339, filed by taxpayer. 9-29-30 Granted.
Oct. 4—Hearing set Dec. 2, 1930.
" 29—Notice to send all papers to Mr. Robt. Ash filed by L. E. Fiske.
Nov. 1—Agreed statement of facts filed.
Dec. 2—Hearing had before Judge Marquette, Div. 1. Submitted—assigned to Mr. Trussell, Div. 6. Briefs due Jan. 5, 1931.

" 31—Motion for extension to Feb. 4, 1931, to file brief filed by G. C. 1-5-31 Granted both parties.

1931
Jan. 2—Transcript of hearing 12-2-30 filed.
" 5—Brief filed by taxpayer.
" 31—Brief filed by G. C.
Apr. 24—Motion to supplement brief filed by taxpayer. 4-27-31 Granted.
June 29—Findings of facts and opinion rendered—Mr. Trussell (6). Judgment will be entered rule 50.
July 1—Notice of settlement filed by taxpayer. 7-8-31 Copy served.
" 1—Motion to recall decision, filed by G. C.
" 7—Hearing set July 22, 1931, on settlement.
" 10—Hearing set July 22, 1931, on motion.
" 22—Hearing had before Mr. Smith, Div. 5, on settlement rule 50, & motion. Referred to Mr. Trussell, Div. 6. (Settlement not contested.)
Aug. 5—Transcript of hearing 7-22-31 filed.
" 27—Order denying motion to reconsider findings of facts and opinion, and decision entered.

1932
Feb. 9—Petition for review to U. S. Cir. Ct. of Ap. (4) with assignments of error, filed by G. C.
" 10—Proof of service filed.
Apr. 2—Certified copy of order extending time to May 9, 1932, to complete & transmit record filed.
" 28—Praecipe filed. Proof of service thereon.

(2) Docket No. 49339.

Petroleum Exploration
vs.
Commissioner of Int. Rev.

For Taxpayer: Leland E. Fiske, C. P. A.; Robert Ash, Esq., T. J. Reilly, Esq.; For Commissioner: E. Meacham, Esq., C. E. Lowery, Esq.

DOCKET ENTRIES.

1930
June 23—Petition received and filed. Taxpayer notified. (Fee paid.)
" 24—Copy of petition served on General Counsel.
Aug. 5—Answer filed by G. C.
" 12—Copy served, assigned general calendar.
Sept. 12—Motion to consolidate with dkt. 43480, filed by taxpayer. 9-29-30 Granted.
" 19—Notice of the appearace of Robert Ash, T. J. Reilly and Leland E. Fiske, counsel for taxpayer, filed.
Oct. 4—Hearing set Dec. 2, 1930.
" 29—Notice to mail future notices to Robert Ash, Esq., filed by Leland E. Fiske.
Nov. 1—Agreed statement of facts filed. See 43480.
Dec. 2—Hearing held before J. J. Marquette, Div. 1. Submitted. Assigned to Mr. Trussell. Briefs due Jan. 5, 1931.
Dec. 31—Motion for extension to 2-4-31 to file brief filed by G. C. 1-5-31 Granted both parties.
1931
Jan. 5—Brief filed by taxpayer.
" 2—Transcript of hearing of Dec. 2, 1930, filed.
" 31—Brief filed by G. C.
Apr. 24—Motion for leave to supplement its brief, embodying supplement filed by taxpayer. Grated, 4-27-31.
June 29—Findings of fact and opinion rendered, Sumner L. Trussell, Div. 6. Judgment will be entered pursuant to Rule 50.
July 1—Motion to recall decision filed by G. C.
" 1—Notice of settlement filed by taxpayer. Copy served 7-8-31.
" 10—Hearing set July 22, 1931, on motion.
" 22—Hearing had before Mr. Smith, Div. 5 on settlement under Rule 50 and motion to recall decision. (Settlement not contested.) Referred to Mr. Trussell for decision.
Aug. 5—Transcript of hearing July 22, 1931, filed.
" 27—Decision entered, Mr. Trammell, Div. 2.

1932
Feb. 9—Petition for review by U. S. Cir. Ct. of Ap. (4) with assignments of error filed by G. C.
" 10—Proof of service filed.
Apr. 2—Certified copy of order enlarging time to May 9, 1932, to transmit and to complete record filed.
" 28—Praecipe filed. Proof of service thereon.

PETITION.

(3) Filed Apr. 4, 1929.

UNITED STATES BOARD OF TAX APPEALS.

Petroleum Exploration, Petitioner,
vs.
Commissioner of Internal Revenue, Respondent.
Docket No. 43480

The above named petitioner hereby petitions for a re-determination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (IT:AR:G-5:AGS:60D) dated March 16, 1929, and as a basis of its proceeding alleges as follows:

1. The petitioner is a corporation organized under the Laws of the State of Maine, on September 25, 1916, with principal office at Sistersville, West Virginia. The petitioner is the parent company of the following subsidiaries:

Petroleum Purchasing Company, organized under the laws of Delaware on April 1, 1924, with principal office at Sistersville, West Virginia.

Western Petroleum Exploration, organized under the laws of Maine, on June 7, 1921, with principal office at Sistersville, West Virginia.

2. The notice of deficiency (a copy of which is attached and marked Exhibit A) was mailed to the petitioner on March 16, 1929.

3. The taxes in controversy are income taxes for the calender years 1925 and 1926, and amount to $17,302.50.

4. The determination of tax set forth in the said notice of deficiency is based upon the following errors:

(a) The Commissioner has erred in refusing to add to his depreciation schedules, for the year 1925, for the parent company, the cost of productive oil wells capitalized on the books, and to allow a deduction for depreciation thereon. The Commissioner's depreciation allowance for 1925 on lease equipment is $82,826.35, whereas the correct allowance should be $89,369.57.

(b) The Commissioner has erred in refusing to add to his depreciation schedules, for the year 1926, for the parent company, the cost of productive oil wells capitalized on the books, and to allow a deduction for depreciation thereon. The Commissioner's depreciation allowance for 1926 on lease equipment is $68,105.24, whereas the correct allowance should be $78,192.46.

(4)

(c) The Commissioner erred in refusing to allow as a bad debt deduction, that part of a loan from the parent company to Southern Petroleum Exploration, a Delaware corporation, which was determined to be worthless and charged off during the year 1926.

5. The facts upon which the petitioner relies as the basis of this proceeding are as follows:

(a) During the years 1925 and 1926 Petroleum Exploration drilled a number of productive oil wells, and charged the cost of such wells to capital account. In preparing "Form O" for 1925 and 1926, the cost of these wells was added to the equipment schedules, and depreciation computed thereon. The Commissioner, however, insists that the cost of these wells should be added to the leasehold schedules and returned as depletion. By such action the Commissioner penalizes the petitioner, inasmuch as depletion has been computed on a percentage basis, 27½ per cent of gross income, or 50 per cent of net income, and is not in any way increased by the addition of the drilling costs to the depletion schedules; whereas, when such drilling costs are added to the depreciation schedules, an additional depreciation deduction does result.

(b) Petroleum Exploration owns 75 per cent of the capital stock of Southern Petroleum Exploration, a Delaware Corporation. During the years 1925 and 1926, Petroleum Exploration made a *bona fide* loan to Southern Petroleum Exploration, for the purpose of prospecting for oil, totaling $117,267.80. A proportionate loan of one-third of this amount was made at the same time by the holders of the other 25 per cent of the stock. At the end of 1926, Southern Petroleum Exploration had lost the sum of $62,613.24 in drilling dry holes. Of this sum, $25,000.00 was the paid in capital of Southern Petroleum Exploration; the balance, amounting to $37,613.24, was from funds loaned by Petroleum Exploration and the minority stockholders of Southern Petroleum Exploration. There were no assets from which the loss of $37,613.24 could be repaid, hence it became a bad debt in the hands of the lenders during 1926. Petroleum Exploration's share was 75 per cent, or $28,209.93, and was duly charged off during 1926 as the part of its loan to Southern Petroleum Exploration which became worthless during the taxable year.

6. Wherefore the petitioner prays that the Board may hear the proceeding and prays for relief from the deficiency asserted by the respondent on the following and each of the following particulars:

(a) That the Board find that the capitalized cost of drilling productive oil wells should be returned as depreciation and not as depletion and that the depreciation allowances for Petroleum Exploration made on such wells and associated equipment for 1925 and 1926 should be $89,369.57 and $78,192.46 respectively.

(b) That the Board find that the part of the loan, made by Petroleum Exploration to Southern Petroleum
(5) Exploration, which became worthless and was charged off in 1926, amounted to $28,209.93.

(c) And such other and further relief as the nature of the case may require.

LELAND E. FISKE, C. P. A.,
Counsel for Petitioner,
216 Atlas Life Bldg.,
Tulsa, Okla.

STATE OF WEST VIRGINIA,
County of Tyler, ss.

E. A. Durham, being duly sworn, says that he is the president of the above named petitioner; that he is duly authorized to verify the foregoing petition; that he has read the foregoing petition, or had same read to him, and is familiar with the statements contained therein, and that the facts stated are true, except as to those facts stated to be upon information and belief, and those facts he believes to be true.

E. A. DURHAM.

Subscribed and sworn to before me this 2 day of April, 1929.

J. E. FETTY,
Notary Public.

(Notary Seal).

My commission expires Nov. 8, 1937.

EXHIBIT A.

Treasury Department
Washington

(6) March 16, 1929.

Office of
Commissioner of
Internal Revenue.

Address Reply to
Commissioner of
Internal Revenue
and Refer to
IT:AR:G-5:AGS:60D.

Petroleum Exploration,
Trico Bldg.,
Sistersville, West Virginia.

Sirs:

In accordance with Section 274 of the Revenue Act of 1926, you are advised that the determination of your tax liability for the years 1925 and 1926 discloses a deficiency of $17,302.50, as shown in the statement attached.

The section of the law above mentioned allows you to petition the United States Board of Tax Appeals within sixty days (not counting Sunday as the sixtieth day) from the date of the mailing of this letter for a redetermination of your tax liability.

However, if you do not desire to petition, you are requested to execute the inclosed Form 866 and forward both original and duplicate to the Commissioner of Internal Revenue, Washington, D. C., for the attention of IT:C:P-7. The signing of this agreement form will expedite the closing of your return by permitting an early assessment of any deficiencies and preventing the accumulation of interest charges, since the interest period terminates thirty days after filing the agreement form, or on the date assessment is made, whichever is earlier; Whereas, if no agreement is filed, interest will accumulate to the date of the assessment of the deficiencies.

Respectfully,

D. H. BLAIR, Commissioner,
By C. B. ALLEN,
Deputy Commissioner.

Inclosures:
Statement
Form 866-C. R.
Form 882.
Schedules 1 to 9, inclusive.

(7) Exhibit A Continued.

Statement.

IT:AR:G-5
AGS-60D

Parent	Years	Form
Petroleum Exploration Sistersville, West Virginia	1925	1120 Consolidated
	1926	1120 Consolidated
Subsidiary Companies:		
Western Petroleum Exploration Sistersville, West Virginia.	1925 1926	
Petroleum Purchasing Company Sistersville, West Virginia	1925 1926	

Tax Liability

Petroleum Exploration

Year	Corrected Tax Liability	Tax Previously Assessed	Deficiency
1925	$40,146.64	$29,884.38	$10,262.26
1926	53,565.68	46,525.44	7,040.24
Total	$93,712.32	$76,409.82	$17,302.50

Your protest dated January 17, 1929, Revenue Agent's report covering the years 1925 and 1926 and Bureau letter dated December 22, 1928, have been made the basis of this audit.

In determining your tax liability as stated herein, careful consideration has been given to the statements set forth in the following claims:

Kind	Amount	Year	Date Filed
Refund	$2,066.30	1925	March 3, 1928
Refund	781.35	1926	March 3, 1928

A carbon copy of this letter has been mailed to Leland E. Fiske, in accordance with the authorization contained in your power of attorney running to him which is on file in this office.

Consents which will expire December 31, 1929, are on file for the years 1924 and 1925.

(8) Exhibit A Continued.

-1-

Petroleum Exploration. Year Ended December 31, 1925.

Schedule 1

Net Income

Net income as disclosed by return	$212,774.80
As corrected	211,202.61
Net adjustment	$ 1,572.19

Unallowable deductions and additional income:		
(a) Expense	$ 865.16	
(b) Depreciation	3,360.57	
Total		$ 4,225.73
Nontaxable income and additional deductions:		
(c) Depletion	$1,271.52	
(d) Losses	4,526.40	
Total		5,797.92
Net adjustments as above		$ 1,572.19

Explanation of Items Changed

(a) Expense		$ 865.16

Legal costs to validate titles are held to be a part of the cost of the particular property and not an allowable deduction from gross income.

(b) Depreciation		$ 3,360.57
Excessive depreciation of Miscellaneous Assets	$ 2,474.50	
Excessive depreciation of Lease Equipment	886.07	
Total		$ 3,360.57

For further explanation see Schedules F and G attached to a Revenue Agent's report for the year 1925, a copy of which has been furnished to you.

(9) Exhibit A Continued.

-2-

Petroleum Exploration. Year Ended December 31, 1925.

Schedule 1 Continued.

Explanation of Items Changed
(continued)

(c) Depletion		$ 1,271.52

Depletion allowable	$302,012.87	
Depletion deducted	300,741.35	
Additional depletion allowable		$ 1,271.52

For depletion allowable see the attached Valuation Report.

(d) Losses		$ 4,526.40
Increased loss on Carbon Black plant		$ 7,709.83
Decrease in loss on casings		3,183.43
Losses allowable		$ 4,526.40

The loss on Carbon Black plant has been increased to take care of a retaining wall which is of no further value when the Carbon Black plant is abandoned. Losses on casings which are applicable to prior years are not an allowable deduction for the current year.

Schedule 2

Western Petroleum Exploration.

Net Income

Net loss as disclosed by return		$ 77,842.70
As corrected—net loss		287.48
Net adjustments		$ 77,555.22
Unallowable deductions and additional income:		
(a) Depletion	$ 1,228.11	
(b) Losses	77,934.04	
Total		$ 79,162.15
Additional deduction:		
(c) Depreciation		1,606.93
Net adjustment as above		$ 77,555.22

(10) Exhibit A Continued

–3–

Petroleum Exploration
Western Petroleum Exploration.

Year ended December 31, 1925.

Schedule 2
(continued)

Explanation of Items Changed.

(a) Depletion		$ 1,288.11
Depletion deducted	$11,530.32	
Depletion allowable	10,302.21	
Depletion disallowed	$ 1,228.11	

See the attached Valuation Report for depletion allowable.

(b) Losses	$ 77,934.04
Loss on Syndicate account.	

The Bureau holds that this loss is not determinable.

(c) Depreciation	$ 1,606.93

This item is additional depreciation allowable as disclosed by Exhibit F of Revenue Agent's report for 1925.

Schedule 3

Petroleum Purchasing.

Net Income

Net Income as disclosed by return	$ 94,947.77
As corrected	97,912.84
Net adjustment	$ 2,965.07
Unallowable deduction:	
(a) Inventory	$ 2,977.05
Additional deduction:	
(b) Depreciation	11.98
Net adjustments as above	$ 2,965.07

(11) Exhibit A Continued

-4-

Petroleum Exploration
Petroleum Purchasing

Year ended December 31, 1925.

Schedule 3
(continued)

Explanation of Items Changed

(a) Inventory		$ 2,977.05
Decrease in opening inventory	$2,579.57	
Decrease in closing inventory	2,397.48	
Total increase to income	$2,977.05	

See Exhibit G of Revenue Agent's report for the year 1925, a copy of which has been furnished to you.

(b) Depreciation $ 11.98

See Schedule F of the above mentioned report.

Schedule 4

Net income as corrected:	
Petroleum Exploration	$211,202.61
Petroleum Purchasing Company	97,912.84
Total	$309,115.45
Net losses as corrected:	
Western Petroleum Exploration	287.48
Aggregate net income	$308,827.97
Adjustments:	
Add: Intercompany profit in inventory December 31, 1924	26,204.28
Total	$335,032.25
Deduct: Intercompany profit in inventory December 31, 1925	26,211.97
Consolidated net income	$308,820.28

(12) Exhibit A Continued

-5-

Petroleum Exploration Year ended December 31, 1925

Schedule 5

Computation of Tax

Income Tax

Net income for taxable year subject to tax at 13 per cent	$308,820.28
Total tax assessable	$ 40,146.64
Total previously assessed	29,884.38
Additional tax to be assessed	$ 10,262.26

Schedule 6

Year ended December 31, 1926.

Net Income

Net income as disclosed by return		$289,630.37
As corrected		336,776.75
Net adjustment		$ 47,146.38
Unallowable deductions and additional income:		
(a) Depreciation	$ 1,938.16	
(b) Bad debts	46,959.93	
Total		$ 48,898.09
Nontaxable income and additional deductions:		
(c) Depletion	$ 713.92	
(d) Loss on Autos and Fixtures	854.80	
(e) Casing lost	182.99	
Total		1,751.71
Net adjustment as above		$ 47,146.38

(13) Exhibit A continued.

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Petroleum Exploration Year ended December 31, 1926.

Schedule 6
(continued)

Explanations of Items Changed.

(a)	Depreciation			$ 1,938.16
	Depreciation deducted		$79,403.26	
	Depreciation allowable, lease equipment	$68,105.24		
	Depreciation allowable, miscellaneous assets	9,359.86	77,465.10	
	Depreciation disallowed		$ 1,938.16	
(b)	Bad debts			$ 46,959.93

This is 75 per cent of the amount of the deficit of the Southern Petroleum Exploration Company, which you deduct as a bad debt. The Bureau holds that the amount has not been determined as a bad debt.

(c)	Depletion			$ 713.92
	Depletion allowable		$277,900.70	
	Depletion deducted		277,186.78	
	Additional depletion allowable		$ 713.92	
(d)	Losses on auto and Fixtures			$ 854.80

The losses are allowed as disclosed in Exhibit P of Revenue Agent's report for 1925.

(e)	Casing lost	$ 182.99

Casing lost and abandoned were charged to Reserve for depreciation of lease equipment is now allowed as a deduction from gross income.

(14) Exhibit A Continued.

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Petroleum Exploration Year ended December 31, 1926.
Western Petroleum Exploration

Schedule 7

Net Income

Net income as disclosed by return		$ 47,841.41
As corrected		55,197.01
Net adjustment		$ 7,355.60
Unallowable deductions and additional income:		
(a) Profit on sale of leases	$13,994.25	
Nontaxable income and additional deductions:		
(b) Depletion	6,638.65	
Net adjustment as above		$ 7,355.60

Explanation of Items Changed

(a) Profit on sale of leases $ 13,994.52

Profit on sale of leases has been increased by the depletion computed on cost for the year 1926.

(b) Depletion $ 6,638.65

Depletion has been increased to the proper amount on the cost basis:

Depletion on Cost	$13,994.25
Depletion deducted	7,355.60
Additional depletion	$ 6,638.65

Schedule 8

Petroleum Purchasing Company.

Net Income

Net Income as disclosed by return	$ 31,795.63
As corrected	28,330.72
Net adjustment	$ 3,464.91

(15) Exhibit A Continued.

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Petroleum Exploration Year ended December 31, 1926.
Petroleum Purchasing Company.

Schedule 8
(continued)

Additional income:	
(a) Inventory	$ 3.39
Additional deduction:	
(b) Depreciation	3,468.30
Net adjustment as above	$ 3,464.91

Explanation of Items Changed

(a) Inventory $ 3.39

This adjustment is disclosed in Revenue Agent's report for the year 1926, Exhibit B, a copy of which has been furnished to you.

(b) Depreciation $ 3,468.30

See Exhibit F of the above mentioned report.

Schedule 9

Petroleum Exploration.

Net Income as corrected:	
Petroleum Exploration	$336,776.75
Western Petroleum Exploration	55,197.01
Petroleum Purchasing Company	28,330.72
Total	$420,204.48
Deduct:	
Intercompany profit in inventories	23,521.64
Consolidated net income	$396,782.84

Schedule 10

Computation of Tax

Income Tax

Net Income for taxable year subject to tax at 13½ per cent	$396,782.84
Total tax assessable	$ 53,565.68
Total previously assessed	46,525.44
Additional tax to be assessed	$ 7,040.24

ANSWER.

(16) Filed May 27, 1929.

UNITED STATES BOARD OF TAX APPEALS.

Petroleum Exploration, Petitioner,
vs.
Commissioner of Internal Revenue, Respondent.
} Docket No. 43480

The Commissioner of Internal Revenue by his attorney, C. M. Charest, General Counsel Bureau of Internal Revenue, for answer to the petition of the above named taxpayer, admits and denies as follows:

1. Admits the allegations contained in Paragraph 1.

2. Admits the allegations contained in Paragraph 2.

3. Admits that the taxes in controversy are income taxes for the calendar years 1925 and 1926, and that the notice of deficiency shows deficiencies in tax for said years in the respective amounts of $10,262.26 and $7,040.24.

4 (a), (b) and (c). Denies that the Commissioner has committed errors as alleged in subparagraphs (a), (b) and (c) of Paragraph 4.

5 (a) and (b). Denies the allegations contained in subparagraphs (a) and (b) of Paragraph 5.

6. Denies generally and specifically each and every allegation in taxpayer's petition not hereinbefore admitted, qualified, or denied.

Wherefore, it is prayed that the taxpayer's appeal be denied.

(Signed) C. M. CHAREST,
General Counsel,
Bureau of Internal Revenue.

Of Counsel:

EUGENE MEACHAM,
C. E. LOWERY,
Special Attorneys,
Bureau of Internal Revenue.

PETITION.

(17) Filed June 23, 1930.

UNITED STATES BOARD OF TAX APPEALS.

Petroleum Exploration, Petitioner,
vs.
Commissioner of Internal Revenue, Respondent.
Docket No. 49339

The above named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (IT:AR:G-3:CB) dated June 13, 1930, and as a basis of its proceeding alleges as follows:

1. The petitioner is a corporation organized under the Laws of the State of Maine, on September 25, 1916, with principal office at Sistersville, West Virginia. The petitioner is the parent company of the following subsidiary;

Petroleum Purchasing Company, organized under the laws of Delaware on April 1, 1924, with principal office at Sistersville, West Virginia.

2. The notice of deficiency (a copy of which is attached and marked Exhibit A) was mailed to the petitioner on June 13, 1930.

3. The taxes in controversy are income taxes for the calendar year 1927 and amount to $4,404.21.

4. The determination of tax set forth in the said notice of deficiency is based upon the following errors:

(a) The Commissioner has erred in refusing to add to his depreciation schedules, for the year 1927, for the parent company, the cost of productive oil wells capitalized on the books of account, and to allow a deduction for depreciation thereon. The Commissioner's depreciation allowance for 1927 on lease equipment is $66,015.91, whereas the correct allowance should be $75,427.20.

5. The facts upon which petitioner relies as the basis of this proceeding are as follows:

(a) During the years 1925, 1926 and 1927 Petroleum Exploration drilled a number of productive oil wells, and charged the cost of such wells to capital account. In preparing "Form O" for these years, the cost of these wells was added to the equipment schedules, and depreciation computed thereon. The Commissioner, however, insists that the cost of these wells should be added to the leasehold schedules and returned by depletion. By such (18) action the Commissioner penalizes the petitioner, inasmuch as depletion has been computed on a percentage basis, 27½ per cent of gross income, or 50 per cent of net income, and is not in any way increased by the addition of the drilling costs to the depletion schedules; whereas, when such drilling costs are added to the depreciation schedules, an additional depreciation deduction does result.

6. Wherefore the petitioner prays that the Board may hear the proceeding and prays for relief from the deficiency asserted by the respondent on the following and each of the following particulars:

(a) That the Board find that the capitalized cost of drilling productive oil wells should be returned as depreciation and not as depletion and that the depreciation allowance for Petroleum Exploration, on such wells and associated equipment, for 1927, should be $75,427.20.

(b) And such other and further relief as the nature of the case may require.

LELAND E. FISKE, C. P. A.,
Counsel for Petitioner,
1181 North Boston Ave.,
Tulsa, Okla.

STATE OF WEST VIRGINIA,
County of Tyler, ss:

E. A. Durham, being duly sworn, says that he is the president of the above named petitioner; that he is duly authorized to verify the foregoing petition; that he has read the foregoing petition, or had same read to him, and is familiar with the statements contained therein, and that the facts stated are true, except as to those facts stated to be upon information and belief, and those facts he believes to be true.

E. A. DURHAM.

Subscribed and sworn to before me this 20 day of June 1930.

J. E. FETTY,
Notary Public.

(Notary's Seal)

My Commission Expires Nov. 8, 1937.

EXHIBIT A.

Treasury Department
Washington

(19) June 13, 1930.

Office of Commisioner
of Internal Revenue
IT:AR:G-3:GB.

Petroleum Exploration, Incorporated,
Trico Bldg.,
Sistersville, West Virginia.

Sirs:

You are advised that the determination of your tax liability for the year 1927 discloses a deficiency of $4,-404.21, as shown in the statement attached.

In accordance with section 274 of the Revenue Act of 1926, notice is hereby given of the deficiency mentioned. Within sixty days (not counting Sunday as the sixtieth day) from the date of the mailing of this letter, you may petition the United States Board of Tax Appeals for a redetermination of your tax liability.

HOWEVER, IF YOU DO NOT DESIRE TO PETITION, you are requested to execute the enclosed agreement form and forward it to the Commissioner of Internal Revenue, Washington, D. C., for the attention of IT:C:P-7. The signing of this agreement will expedite the closing of your return by permitting an early assessment of any deficiency and preventing the accumulation of interest charges, since the interest period terminates thirty days after filing the enclosed agreement, or on the date assessment is made, which ever is earlier; WHEREAS IF NO AGREEMENT IS FILED, interest will accumulate to the date of assessment of the deficiency.

Respectfully,

ROBT. H. LUCAS, Commissioner,
By DAVID BURNET,
Deputy Commissioner.

Enclosures:
Statement
Form 882
Form 870
Schedules 1 to 4, incl.

(20) IT:AR:G—3:CB.

Statement of Returns Examined,
and
Resulting Tax Liability.

Returns Examined

Parent or Principal Company	*Year*	*Form*
Petroleum Exploration, Incorporated, Sistersville, West Virginia	1927	1120 Consolidated
Subsidiary		
Petroleum Purchasing Company Sistersville, West Virginia	1927	1122

Tax Liability

Petroleum Exploration, Incorporated.

Year	Corrected Tax Liability	Tax Previously Assessed	Over-Assessment	Deficiency
1927	$30,524.10	$26,119.89	0.00	$4,404.21

Revenue Agent's report covering the year 1927, a copy of which has been furnished you, has been used as the basis of this examination.

Consistent with the findings of this office for the year 1926, the Revenue Agent's report is sustained in the disallowance of the item of Bad Debts, $20,812.27, and your contention in your protest against the Revenue Agent's report is denied that you be allowed a deduction of this amount representing seventy-five per cent of the Southern Petroleum Exploration's loss for the year 1927.

The item of $1,433.19 deducted and disallowed as being prior years expense has been allowed based upon statement contained in your protest mentioned above.

The deficiency and/or overassessment set forth herein has been allocated to Petroleum Exploration, Incorporated.

Preliminary thirty-day letter was mailed, dated April 16, 1930, and protest thereto was filed, dated May 16, 1930.

The returns for the years 1925 and 1926 are before the Board of Tax Appeals on appeal Docket Number 43480, involving the same points as are in dispute for the present year 1927.

(21) Petroleum Exploration, Incorporated

Year ended December 31, 1927.

Schedule 1

Net Income

Net income as disclosed by books		247,854.04
As corrected		172,500.55
Net adjustment		75,353.49
Unallowable deductions and additional income:		
(a) Income Tax Reserve	24,852.67	
(b) Bad Debts disallowed	20,812.27	
(c) Legal Costs Capitalized	300.00	
(d) Profit on Sale of Auto	350.00	
(e) Depreciation on lease equipment	10,191.23	
(f) Depreciation on other assets	1,673.59	
(g) Depletion disallowed	490.95	
Total		58,670.71
Nontaxable income and additional deductions:		
(h) Bad Debts deducted on return	812.27	
(i) Depletion on appreciation	133,211.93	
Total		134,024.20
Net Adjustment as Above		75,353.49

Explanation of Items Changed.

(a) Income Tax Reserve	24,852.67
(h) Bad Debts	812.27
(i) Depletion on Appreciation	133,211.93

The above three adjustments appear on the original return filed, resulting in a net income of $138,682.51 as shown by the return. These adjustments have been approved by the Bureau.

(b) Bad Debts disallowed 20,812.27

This amount represents three-fourths of Southern Petroleum Exploration's loss for 1927. The two corporations are not affiliated for income tax purposes. It is shown that $20,000.00 of the amount disallowed was credited to the Bad Debt Reserve. The balance of $812.27 was taken as an additional deduction on the return.

The Petroleum Exploration Company owns three-fourths of the Capital Stock of the Southern Petroleum Exploration. Its advances to the end of the taxable year amounted to $164,187.03. A similar deduction was disallowed in the examination for 1926, as Section 214, relied upon by you does not permit a stockholder to deduct its proportionate share of the deficit of a corporation in which it holds stock. Southern Petroleum Exploration is still in business and has some producing wells. It also has assets from which recovery in part is possible.

(22) (c) Legal costs capitalized 300.00

Legal costs in connection with the M. P. G. tract have been set up as a deferred legal charge pending the outcome of litigation. This amount represents the costs of reviewing a bond in connection with the proceedings. It has been capitalized as it relates to the same subject matter, the legal costs of which has been treated in this manner. You have filed no protest against this adjustment.

(d) Profit on the sale of automobile 350.00

This amount represents the sale price of a Buick automobile used at the Montana branch. It was credited to the auto account. The records show that no Buick automobile was bought for this branch after 1921. The previous Revenue Agent's reports show that the item was fully depreciated prior to the taxable year so that the entire sales price is taxable income.

(e) Depreciation on lease equipment 10,191.23

This amount has been computed as follows, taking into consideration your protest dated January 30, 1929:

Depreciation deducted on Return
In operating expenses 86,475.55

In administrative expenses	3,854.60	
Carbon Black Plant	4,684.41	
Total amount deducted		95,014.56
Less:		
Depreciation on Miscellaneous Assets	18,957.42	
Depreciation on Land Department cars capitalized on books and not claimed on the return	150.00	18,807.42
Depreciation of Lease Equipment		76,207.14
Amount allowed by the Bureau		66,015.91
Amount disallowed as excessive		10,191.23

(f) Depreciation on other assets 1,673.59

This amount was computed as follows:

Depreciation deducted on return	18,807.42	
Amount allowed as computed by the Revenue Agent and accepted by the Bureau	17,133.83	
Amount disallowed		1,673.59

(g) Depletion disallowed 490.95

A depletion rate has been established by the Bureau upon the basis of information submitted by you and other data on hand in this office.

(23) (g) Continued.

Depletion deducted on return		
Depletion on cost	36,153.43	
Depletion on appreciation	133,211.93	
Total deducted		169,365.36
Amount allowed by the Bureau		168,874.41
Amount disallowed		490.95

Schedule 2

Petroleum Purchasing Company.

Net Income

Net income as disclosed by books		12,438.88
As corrected		12,180.38
Net adjustment		258.50
Nontaxable income and additional deductions:		
(a) Adjusting inventory, Dec. 31, 1927	241.28	
(b) Difference in opening inventory	3.39	
(c) Reduction in closing inventory	13.83	
Total		258.50

Schedule 3

Petroleum Exploration, Incorporated

Consolidated Net Income, 1927

Net income as corrected		
Petroleum Exploration, Incorporated	172,500.55	
Petroleum Purchasing Company	12,180.38	
Intercompany Inventory Loss	41,423.53	
Total		226,104.46

Schedule 4

Computation of Tax
Income Tax

Net income for taxable year, subject to tax		266,104.46
Income tax at 13½ percent		30,524.10
Total tax assessable	30,524.10	
Tax previously assessed	26,119.89	
Additional tax to be assessed		4,404.21

ANSWER.

(24) Filed Aug. 5, 1930.

UNITED STATES BOARD OF TAX APPEALS.

Petroleum Exploration, Petitioner,
vs.
Commissioner of Internal Revenue,
Respondent.
} Docket No. 49339

The Commissioner of Internal Revenue by his attorney, C. M. Charest, General Counsel, Bureau of Internal Revenue, for answer to the petition of the above named taxpayer, admits and denies as follows:

1. Admits the allegations contained in Paragraph 1.

2. Admits that the notice of deficiency was mailed to the petitioner on June 13, 1930.

3. Admits the allegations contained in Paragraph 3.

4 (a). Denies that the Commissioner has committed any error as alleged in Paragraph (4a).

5 (a). Denies the allegations contained in Paragraph 5 (a).

6. Denies generally and specifically each and every allegation contained in taxpayer's petition and not hereinbefore admitted, qualified, or denied.

Wherefore, it is prayed that the taxpayer's appeal be denied.

(Signed) C. M. CHAREST,
General Counsel,
Bureau of Internal Revenue.

Of Counsel:

EUGENE MEACHAM,
C. E. LOWERY,
Special Attorneys,
Bureau of Internal Revenue.

MOTION TO CONSOLIDATE.

(25) Filed Sep. 12, 1930.

UNITED STATES BOARD OF TAX APPEALS.

Petroleum Exploration, Petitioner,
vs.
Commissioner of Internal Revenue, Respondent.
} Docket No. 43480

Comes now the above named taxpayer by its counsel Robert Ash and T. J. Reilly and moves that this case be consolidated with Docket No. 49339.

The reasons for this motion are: Docket No. 49339 is for the taxable year 1927 and presents an issue regarding depreciation. This is the only issue in the case. In Docket No. 43480 the identical question is presented for the years 1925 and 1926. To try these cases on separate records would serve no useful purpose.

Wherefore, it is prayed that this motion be granted.

ROBERT ASH,
T. J. REILLY,
Munsey Building,
Washington, D. C.
Attorneys for Petitioner.

Granted Sep. 27, 1930.

(Signed) PERCY W. PHILLIPS,
U. S. Board of Tax Appeals.

FINDINGS OF FACT AND OPINION.

(26) 23 B. T. A. ——.

UNITED STATES BOARD OF TAX APPEALS.

Petroleum Exploration, Petitioner,
vs.
Commissioner of Internal Revenue, Respondent.

Docket Nos. 43480, 49339. Promulgated June 29, 1931.

Deduction—Depreciation. Amounts expended by petitioner during 1925, 1926 and 1927, representing cost of drilling productive oil wells, of freight and haulage and of labor employed in installing equipment in the wells, all of which cost was capitalized, *held*, to be recoverable through depreciation rather than depletion. *A. T. Jergins Trust*, 22 B. T. A. 551, followed.

Robert Ash, Esq., T. J. Reilly, Esq., and *Leland E. Fiske, C. P. A.*, for the petitioner. *Eugene Meacham, Esq.*, for the respondent.

In these proceedings, consolidated for hearing, the respondent has determined income tax deficiencies in the amounts of $10,262.26, $7,040.24 and $4,404.21 for the calendar years 1925, 1926 and 1927, respectively, and the sole issue presented for our determination is raised by petitioner's contention that the capitalized cost of drilling oil wells, of haulage and of installing equipment in the wells, is recoverable through depreciation instead of through depletion as determined by respondent. The petitioner abandoned the issue relative to a claimed bad debt deduction for 1926.

FINDINGS OF FACT.

(27) The petitioner is a corporation organized on September, 25, 1916, under the laws of the State of Maine, and its principal office is at Sistersville, W. Va.

The petitioner is the parent company of the following subsidiaries:

Petroleum Purchasing Company, organized on April 1, 1924, under the laws of Delaware, with principal office at Sistersville. Western Petroleum Exploration, organized on June 7, 1921, under the laws of Maine, with principal office at Sistersville.

The parties hereto have submitted the following stipulation of facts:

1. On December 31, 1924, the undepreciated investment of Petroleum Exploration in equipment in oil wells amounted to $475,975.02.

2. During the years 1925, 1926 and 1927 Petroleum Exploration capitalized on its books of account the total cost of new productive oil wells drilled, such charges representing amounts paid for equipment put into the wells, amounts paid to drilling contractors for drilling the wells, amounts paid for freight and haulage of the equipment, and amounts paid for labor in installing the equipment in the wells, as follows:

Year	Cost of Equipment	Cost of Drilling Wells, Hauling & Placing Equipment	Total Cost of Completed Producing Wells
1925	$121,303.03	$49,640.17	$170,943.20
1926	15,882.88	52,994.14	68,887.02
1927	56,626.31	2,659.26	59,285.57

3. The productive life of all producing wells, the total cost of which was capitalized as shown in paragraph No. 2, is more than one year.

4. Depreciation has been claimed by the petitioner and allowed by the Commissioner at a unit production rate, based on the length of life of the oil deposits.

5. The Commissioner, in making his computation of depreciation, has added to his depreciation schedules the cost of the equipment added each year, as shown in paragraph No. 2, but has not added the cost of drilling wells, hauling and placing the equipment.

(28) 6. Instead, the cost of drilling wells, hauling and placing the equipment, as shown in paragraph No. 2, has been added to the cost depletion schedules by the Commissioner; but depletion has been allowed on a statutory percentage basis (27½ per cent of gross income, not to exceed 50 per cent of net income) and is not based on cost.

7. The petitioner, in making its computation of de-

preciation as shown in its "Form O", has added the total cost of completed wells, including equipment, drilling, hauling and placing the equipment, to its depreciation schedules, no part of the cost of the wells being added to the cost depletion schedules.

8. If petitioner's method of computing depreciation be sustained by the Board, namely, by adding to the undepreciated investment shown in paragraph No. 1 the total cost of completed wells as shown in paragraph No. 2 (no part of such cost being added to the depletion schedules) an increase in the depreciation allowance will result as follows:

DEPRECIATION ALLOWANCE

Year	Computed by Commissioner's Method	Computed by Petitioner's Method	Increase in Depreciation Allowance if Petitioner's Method be sustained
1925	$82,826.35	$89,369.57	$ 6,543.22
1926	68,105.24	78,192.46	10,087.22
1927	66,015.91	75,161.03	9,145.12

9. If petitioner's method of computing depreciation be sustained, as shown in paragraph No. 8, a decrease in the depletion allowance will result as follows:

DEPLETION ALLOWANCE

Year	Computed by Commissioner's Method	Computed by Petitioner's Method	Decrease in Depletion Allowance if Petitioner's Method be sustained
1925	$302,012.87	$300,860.43	$1,152.44
1926	277,900.70	275,191.94	2,708.76
1927	168,874.41	167,486.55	1,387.86

OPINION.

(29) TRUSSELL: In the case of *A. T. Jergins Trust*, 22 B. T. A. 551, we held, under the applicable provisions of the Revenue Acts of 1921 and 1924, that capitalized

expenditures of the type involved in the instant case, are recoverable through depreciation rather than depletion. The instant case involves the years 1925, 1926 and 1927 and the applicable provisions of the 1926 Act are to the same effect as those of the 1924 Act. Accordingly, our decision in *A. T. Jergins Trust, supra,* is controlling and upon authority of that decision the petitioner's contention is sustained and the respondent's determination reversed.

Judgment will be entered pursuant to Rule 50.

(30) **DECISION.**

UNITED STATES BOARD OF TAX APPEALS.

Petroleum Exploration, Petitioner,
vs.
Commissioner of Internal Revenue, Respondent.
} Docket Nos. 43480, 49339.

The Board having heretofore under date of June 29, 1931, promulgated its findings of fact and opinion herein directing that decision be entered under Rule 50, and counsel for respondent having filed a motion for recall and reconsideration of said findings of fact and opinion, and counsel for petitioner having filed a proposed recomputation of the deficiencies as redetermined under the aforesaid findings of fact and opinion, and hearing on said motion for recall and reconsideration and said proposed recomputation having been had pursuant to due notice, and due consideration having been given to said motion and said recomputation it is

Ordered, that said motion for recall and reconsideration of the findings of fact and opinion be and the same is hereby denied, and it is further

Ordered and Decided, that the deficiencies for the years 1925, 1926 and 1927 are $9,561.45, $6,044.15 and $3,356.98, respectively.

(Seal) (Signed) C. M. TRAMMELL, Member.

Entered Aug. 27, 1931.

Certified Copy sent to each party.

PETITION FOR REVIEW AND ASSIGNMENTS OF ERROR.

(31) Filed Feb. 9, 1932.

IN THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT.

David Burnet, Commissioner of Internal Revenue, Petitioner,
vs.
Petroleum Exploration, Respondent.

Docket Nos. 43480 & 49339.

To the Honorable Judges of the United States Circuit Court of Appeals for the Fourth Circuit:

Now Comes David Burnet, Commissioner of Internal Revenue, by his attorneys, G. A. Youngquist, Assistant Attorney General, C. M. Charest, General Counsel, Bureau of Internal Revenue, and Chester A. Gwinn, Special Attorney, Bureau of Internal Revenue, and respectfully shows:

I.

That he is the duly appointed, qualified, and acting Commissioner of Internal Revenue, appointed and holding his office by virtue of the laws of the United States; that the Petroleum Exploration is a corporation organized on September 25, 1916, under the laws of Maine with principal office at Sisterville, West Virginia. That the income tax returns of said corporation for the calendar years 1925, 1926, and 1927 were made to the Collector of Internal Revenue for the district of West Virginia whose office is located in Parkersburg, West Virginia, which is within the jurisdiction of the United States Circuit Court of Appeals for the Fourth Circuit.

II.

(32) The nature of the controversy is as follows, to-wit:

The question upon which the petitioner seeks review

by this court is whether the respondent is entitled to recover capitalized intangible expenses such as wages, fuel, repairs, hauling, etc., in connection with the exploration, development, and drilling of oil wells (such expenses not being represented by physical property) through annual deductions for depletion as provided by Article 223 of Regulations 69 (promulgated under the Revenue Act of 1926) or through annual deductions for depreciation as decided by the Board of Tax Appeals.

On December 31, 1924, the undepreciated investment of the taxpayer in equipment in oil wells amounted to $475,975.02. During the years 1925, 1926, and 1927 the taxpayer capitalized on its books of account the total cost of new productive oil wells drilled, such charges representing amounts paid for equipment put into the wells, amounts paid to drilling contractors for drilling the wells, amounts paid for freight and haulage of the equipment, and amounts paid for labor in installing equipment as follows:

Year	Cost of Equipment	Cost of Drilling Wells, Hauling & Placing Equipment	Total Cost of Completed Producing Wells
1925	$121,303.03	$49,640.17	$170,943.20
1926	15,882.88	52,994.14	68,887.02
1927	56,626.31	2,659.26	59,285.57

It was stipulated by the parties and found by the Board of Tax Appeals that the productive life of all producing wells, the total cost of which was capitalized as stated above, is more than one year. That the taxpayer claimed and the Commissioner allowed deductions for (33) depreciation on said capital investment at a unit production rate, based on the life of the oil deposits; that the Commisioner in computing depreciation included the cost of equipment added each year, as shown above, but did not include the cost of drilling wells, hauling and placing the equipment.

It was further agreed and found by the Board that the cost of drilling wells, hauling and placing the equipment, as shown in the above table of costs, was added to the cost depletion schedules computed by the Commis-

sioner and depletion thereon was allowed on a statutory percentage basis (27½ per cent of gross income, not to exceed 50 per cent of net income) and not upon cost. The taxpayer in computing depreciation added the total cost of completed wells, including equipment, drilling, hauling, and placing the equipment to its depreciation schedules, no part of the cost of the wells being added to the cost depletion schedules.

If the taxpayer is permitted to add the intangible cost of oil wells, including drilling, hauling, and placing of the equipment, to its depreciation schedules and take annual deductions thereon at the rates allowed for depreciation of its physical property the deductions will be larger and its net income for the years involved correspondingly smaller as shown by the Board's findings of fact.

Upon audit of the taxpayer's income tax returns for the years 1925, 1926 and 1927 the Commissioner determined deficiencies for said years in the respective amounts of $10,262.26, $7,040.24 and $4,404.21 whereupon the taxpayer filed its petitions in the Board of Tax Appeals alleging that the Commissioner committed the following errors:

(34) (a) In refusing to add to taxpayer's depreciation schedules for the years 1925, 1926 and 1927 the cost of productive oil wells capitalized on its books and allow a deduction for depreciation thereon.

(b) In refusing to allow as a deduction for bad debt that part of a loan from the Petroleum Exploration to Southern Petroleum Exploration which was alleged to have been determined to be worthless and charged off during the year 1926.

At the hearing respondent abandoned alleged error (b) and submitted the case to the Board on question (a) alone.

The case was heard by a division of the Board on December 2, 1930, and on June 29, 1931, the Board promulgated its findings of fact and opinion in which it was held that the capitalized expenditures of the type involved in this case are recoverable through depreciа-

tion as contended by the taxpayer rather than through depletion as provided by the Commissioner's regulations.

Thereafter, on August 27, 1931, the Board entered its decision and order of redetermination finding that the deficiencies for the years 1925, 1926, and 1927 are $9,561.45, $6,044.15 and $3,356.98, respectively.

III.

That said Commissioner being aggrieved by the findings of fact and by the conclusions of law contained in said decision and by the said order of redetermination desires to obtain a review thereof by this honorable Court. The Commissioner's assignments of error are as follows:

1. The Board erred in holding that the capitalized intangible cost, including haulage and installation of equipment of drilling oil wells is recoverable by annual deductions for depreciation instead of annual deductions for depletion.

2. The Board erred in its construction of Article 223 of Regulations 69 established under the Revenue Act of 1926.

(35) 3. The Board erred in failing to hold that the capitalized intangible cost of drilling oil wells (including hauling and installing equipment) not represented by physical property is returnable through annual deductions for depletion as provided by Article 223 of Regulations 69.

4. The Board erred in failing to find the deficiencies for the years 1925, 1926 and 1927 in the amounts determined by the Commissioner in his 60-day letters to the taxpayer dated March 6, 1929, and June 13, 1930, i. e., in the amounts of $10,262.26, $7,040.24, and $4,404.21 for the years 1925, 1926 and 1927, respectively.

Wherefore, the Commissioner petitions that the decision of the Board of Tax Appeals be reviewed by the United States Circuit Court of Appeals for the Fourth

Circuit, that a transcript of the record be prepared in accordance with law and with the rules of said Court and transmitted to the clerk of said Court for filing, and that appropriate action be taken to the end that the errors complained of may be reviewed and corrected by said court.

(Sgd) G. A. YOUNGQUIST,
Assistant Attorney General.
(Sgd) C. M. CHAREST,
General Counsel,
Bureau of Internal Revenue.

Of Counsel:

CHESTER A. GWINN,
Special Attorney,
Bureau of Internal Revenue.

UNITED STATES OF AMERICA,
(36) District of Columbia, ss:

C. M. CHAREST, being duly sworn, says that he is General Counsel of the Bureau of Internal Revenue and as such is duly authorized to verify the foregoing petition for review; that he has read said petition and is familiar with the contents thereof; that said petition is true of his own knowledge except as to the matters therein alleged on information and belief, and as to those matters he believes it to be true.

(Sgd) C. M. CHAREST.

Subscribed and sworn to before me this 9th day of February, 1932.

(Sgd) GEORGE W. KREIS,
Notary Public.

My commission expires Nov. 12, 1932.

CAG:tco
2-5-32

PRAECIPE FOR RECORD.

(37) Filed April 28, 1932.

IN THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT.

David Burnet, Commissioner of Internal Revenue, Petitioner, *vs.* Petroleum Exploration, Respondent.	Docket Nos. 43480 & 49339.

To the Clerk of the United States Board of Tax Appeals:

You are requested to prepare and transmit to the Clerk of the United States Circuit Court of Appeals for the Fourth Circuit a transcript of the record in the above entitled cases including the following:

1. Docket entries of proceedings before the Board.

2. All pleadings before the Board including,

(a) Petition filed April 4, 1929, Docket No. 43480.

(b) Petition filed June 23, 1930, Docket No. 49339.

(c) Answer filed May 27, 1929, Docket No. 43480.

(d) Answer filed August 5, 1930, Docket No. 49339.

3. Order of Board entered September 27, 1930, consolidating Docket Nos. 43480 and 49339.

4. Findings of fact and opinion of Board promulgated June 29, 1931.

5. Board's decision and order of redetermination entered August 27, 1931.

6. Petition for review.

7. This praecipe.

The foregoing to be prepared, certified and transmitted on or before May 9, 1932 as required by law and the rules of the United States Circuit Court of Appeals for the Fourth Circuit.

(Signed) C. M. CHAREST,
General Counsel,
Bureau of Internal Revenue.

Service of a copy of the within praecipe is hereby admitted this 26th day of April, 1932.

ROBERT ASH,
Attorney for Respondent.

tco 4-14-32

CERTIFICATE.

(38)

Commissioner of Internal Revenue, Petitioner,
vs.
Petroleum Exploration, Respondent.

Docket Nos. 43480 and 49339.

I, B. D. Gamble, Clerk of the U. S. Board of Tax Appeals, do hereby certify that the foregoing pages 1 to 37, inclusive, contain and are a true copy of the transcript of record, papers and proceedings on file and of record in my office as called for by the Praecipe in the appeal (or appeals) as above numbered and entitled.

In testimony whereof, I hereunto set my hand and affix the seal of the United States Board of Tax Appeals, at Washington, in the District of Columbia, this 5th day of May, A. D., 1932.

(Seal) B. D. GAMBLE, Clerk.

Richmond Press, Inc.,
Richmond, Va.
5-22-31—65

PROCEEDINGS IN THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT

No. 3316

DAVID BURNET, Commissioner of Internal Revenue, Petitioner,

versus

PETROLEUM EXPLORATION, Respondent

On Petition to Review the Decision of the United States Board of Tax Appeals

May 7, 1932, the transcript of record is filed and the cause docketed.

May 7, 1932, motion and order extending the time to May 9, 1932, within which to complete the record and transmit same to this Court are filed.

Same day, the appearance of G. A. Youngquist, Assistant Attorney General, is entered for the petitioner.

May 12, 1932, the appearance of Sewall Key, Special Assistant to the Attorney General; C. M. Charest, General Counsel, Bureau of Internal Revenue, and Mason B. Leming, Special Attorney, Bureau of Internal Revenue, is entered for the petitioner.

May 19, 1932, the appearance of Robert Ash is entered for the respondent.

May 24, 1932, stipulation of attorneys to place the case at the foot of the docket for argument at the June term, 1932, is filed.

May 25, 1932, twenty-five copies of the printed record are filed.

June 27, 1932, the appearance of Andrew D. Sharpe, Special Assistant to the Attorney General, is entered for the petitioner.

ARGUMENT OF CAUSE

June 29, 1932, (June term, 1932) cause came on to be heard before Northcott and Soper, Circuit Judges, and Glenn, District Judge, and is argued by counsel and submitted.

UNITED STATES CIRCUIT COURT OF APPEALS, FOURTH CIRCUIT

No. 3316

DAVID BURNET, Commissioner of Internal Revenue, Petitioner,

versus

PETROLEUM EXPLORATION, Respondent

On Petition to Review the Decision of the United States Board of Tax Appeals

(Argued June 29, 1932. Decided October 3, 1932)

Before Northcott and Soper, Circuit Judges, and Glenn, District Judge

Andrew D. Sharpe, Special Assistant to the Attorney General (G. A. Youngquist, Assistant Attorney General; Sewall Key, Special Assistant to the Attorney General; C. M. Charest, General Counsel, Bureau of Internal Revenue, and Chester A. Gwinn and Charles E. Lowrey, Special Attorneys, Bureau of Internal Revenue, on brief), for Petitioner, and Robert Ash (Leland E. Fiske on brief) for Respondent.

OPINION—Filed October 3, 1932

NORTHCOTT, Circuit Judge:

This is a petition to review a decision of the United States Board of Tax Appeals reported in 23 B. T. A. 890.

The pertinent facts, about which there is no dispute, as found by the Board of Tax Appeals, are as follows:

"The petitioner (the taxpayer) is a corporation organized on September 25, 1916, under the laws of the State of Maine, and its principal office is at Sistersville, W. Va.

* * * * * * *

"The parties hereto have submitted the following stipulation of facts:

" '1. On December 31, 1924, the undepreciated investment of Petroleum Exploration in equipment in oil wells amounted to $475,975.02.

" '2. During the years 1925, 1926 and 1927 Petroleum Exploration capitalized on its books of account the total cost of new productive oil wells drilled, such charges representing amounts paid for equipment put into the wells, amounts paid to drilling contractors for drilling the wells, amounts paid for freight and haulage of the equipment, and amounts paid for labor in installing the equipment in the wells, as follows:

"'Year	Cost of equipment	Cost of drilling wells, hauling & placing equipment	Total cost of completed producing wells
1925	$121,303.03	$49,640.17	$170,943.20
1926	15,882.88	52,994.14	68,887.02
1927	56,626.31	2,659.26	59,285.57

" '3. The productive life of all producing wells, the total cost of which was capitalized as shown in paragraph No. 2, is more than one year.

" '4. Depreciation has been claimed by the petitioner and allowed by the Commissioner at a unit production rate, based on the length of life of the oil deposits.

" '5. The Commissioner, in making his computation of depreciation, has added to his depreciation schedules the cost of the equipment added each year, as shown in paragraph No. 2, but has not added the cost of drilling wells, hauling and placing the equipment.

" '6. Instead, the cost of drilling wells, hauling and placing the equipment, as shown in paragraph No. 2, has been added to the cost depletion schedules by the Commissioner; but depletion has been allowed on a statutory percentage basis (27½ per cent of gross income, not to exceed 50 per cent of net income) and is not based on cost.

" '7. The petitioner, in making its computation of depreciation as shown in its "Form O", has added the total cost of completed wells, including equipment, drilling, hauling an placing the equipment, to its depreciation schedules, no part of the cost of the wells being added to the cost depletion schedules.

"'8. If petitioner's method of computing depreciation be sustained by the Board, namely, by adding to the undepreciated investment shown in paragraph No. 1 the total cost of completed wells as shown in paragraph No. 2 (no part of such cost being added to the depletion schedules) an increase in the depreciation allowance will result as follows:

"'Depreciation Allowance

"'Year	"'Computed by Commissioner's method	Computed by petitioner's method	Increase in depreciation allowance if petitioner's method be sustained
1925	$82,826.35	$89,369.57	$6,543.22
1926	68,105.24	78,192.46	10,087.22
1927	66,015.91	75,161.03	9,145.12

"'9. If petitioner's method of computing depreciation be sustained, as shown in paragraph No. 8, a decrease in the depletion allowance will result as follows:

"'Depletion Allowance

"'Year	"'Computed by Commissioner's method	Computed by petitioner's method	Decrese in depletion allowance if petitioner's method be sustained
1925	$302,012.87	$300,860.43	$1,152.44
1926	277,900.70	275,191.94	2,708.76
1927	168,874.41	167,486.55	1,387.86"

The Statutes and Treasury Regulations involved are:

"Revenue Act of 1926, c. 27, 44 Stat. 9

"Sec. 204. (c) The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the same as is provided in subdivision (a) or (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property, except that—

* * * * * * *

"(2) In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income

from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

"Sec. 234. (a) In computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

* * * * * * *

"(7) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence;

"(8) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee;

"Treasury Regulations 69"

"Art. 221. Depletion in the case of oil and gas wells.—Under section 204 (c) (2), in the case of oil and gas wells, a taxpayer may deduct for depletion an amount equal to 27½ per cent of the gross income from the property during the taxable year, but such deduction shall not exceed 50 per cent of the net income of the taxpayer (computed without allowance for depletion) from the property. In no case shall the deduction computed under this paragraph be less than it would be if computed upon the basis of the cost of the property, or its value at the basic date, as the case may be. In general, "the property", as the term is used in section 204 (c) (2) and this article, refers to the separate tracts or leases of the taxpayer.

"Art. 223. Charges to capital and to expense in case of oil and gas wells.—Such incidental expenses as are paid for

wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of wells, building of pipe lines, and development of the property may, at the option of the taxpayer, be deducted as a development expense or charged to capital account returnable through depletion. If in exercising this option the taxpayer charges these incidental expenses to capital account, in so far as such expense is represented by physical property it may be taken into account in determining a reasonable allowance for depreciation. The cost of drilling non-productive wells may at the option of the operator be deducted from gross income as a development expense or charged to capital account returnable through depletion and depreciation as in the case of productive wells.

An election once made under the provisions of this article will control the taxpayer's returns for all subsequent years. Where deductions for depreciation or depletion have either on the books of the taxpayer or in his returns of net income been included in the past in expense or other accounts, rather than specifically as depreciation or depletion, or where capital expenditures have been charged to expense in lieu of depreciation or depletion, a statement indicating the extent to which this practice has been carried should accompany the return.

"Art. 225. Depreciation of improvements in the case of oil and gas wells.—Both owners and lessees operating oil and/or gas properties will, in addition to and apart from the deduction allowable for depletion as hereinbefore provided, be permitted to deduct a reasonable allowance for depreciation of physical property, such as machinery, tools, equipment, pipes, etc., so far as not in conflict with the option exercised by the taxpayer under article 223. The amount deductible on this account shall be such an amount based upon its cost or other basis equitably distributed over its useful life as will bring such property to its true salvage value when no longer useful for the purpose for which such property was acquired. Accordingly, where it can be shown to the satisfaction of the Commissioner that the reasonable expectation of the economic life of the oil or gas deposit with which the property is connected is shorter than the normal useful life of the physical property, the amount annually deductible for depreciation on such property may be based upon the length of life of the deposit."

The sole question presented is whether the capitalized cost of drilling oil wells and of hauling and placing equipment in the wells is recoverable through allowances for depreciation or depletion. The Commissioner of Internal Revenue determined that this cost was properly recoverable through an allowance for depletion. Upon hearing before the Board of Tax Appeals this determination of the Commissioner was reversed.

The Treasury regulations cited above are authorized by Congress, and while the Secretary of the Treasury cannot by a regulation alter or amend the law (South Carolina Produce Ass'n v. Commissioner, 50 Fed. (2) 742), if within and in accordance with the acts of Congress such regulations have all the force and effect of statutes.

Burnet v. Moore Cotton Mills Co., 49 Fed. (2) 59, and authorities there cited.

Brewster v. Gage, 280 U. S. 327.

Fawcus Machine Co. v. United States, 282 U. S. 375.

It has been repeatedly held by this court, and there is no authority to the contrary, that the action of the Commissioner of Internal Revenue in determining a tax assessment is prima facie correct, and the burden is on the objecting taxpayer to show the action of the Commissioner to be erroneous.

Lehman v. Tait, 58 Fed. (2) 20, and authorities there cited.

Here the taxpayer was given the option under the provisions of Article 223 of Regulations 69 to either charge the expenditures in question to development expense or charge them to capital account *returnable through depletion.* (Italics ours.) This option was exercised by the taxpayer by charging the expenditures to capital account, and by so acting the taxpayer must have done so with the full knowledge that such sums so charged must come back through depletion and not depreciation. This is the plain provision of the Regulation.

It is true that Article 225 of Regulations 69 permits an allowance for depreciation of physical property, but only so far as not to conflict with the option exercised by the taxpayer as to charging such expenditures to capital account, and such allowance is given only for such physical property as "machinery, tools, equipment, pipes, etc." The hole of an oil well itself certainly would not come within this classification, and could not be held to be physical property.

We are here concerned with the cost of putting down the hole through which oil is recovered from under the ground. In the oil well the hole in the ground performs a function, with respect to the oil brought out of the well, similar to that performed by the shaft or tunnel in a mine with respect to the ore brought out of the ground. Neither the shaft nor the hole can be, strictly speaking, termed improvements. They simply serve as conduits through which the mineral is recovered. The bare hole in an oil well does not deteriorate or depreciate as does a piece of machinery or as does the casing with which it is lined, and has no service life other than the period necessary to exhaust the body of the mineral which it reaches. Once the mineral is exhausted the hole is useless and of no value whatever, such as may be possessed by the casing which may be pulled or the machinery which may be removed to be used elsewhere. It seems to us that the proper and logical method of returning to the taxpayer the expense of drilling the hole is through depletion rather than depreciation, this entirely aside from the implied agreement to accept depletion when the taxpayer exercised the option to charge the expense to capital account.

The allowance for depletion was intended by Congress to restore to the taxpayer his capital investment with respect to the oil and gas wells as that investment is used up or exhaus-ed.

In Lynch, Executrix, v. Alworth-Stephens Co., 267 U. S. 364, the Supreme Court said:

"It is said that the depletion allowance applies to the physical exhaustion of the ore deposits, and since the title thereto is in the lessor, he alone is entitled to make the deduction. But the fallacy in the syllogism is plain. The deduction for depletion in the case of mines is a special application of the general rule of the statute allowing a deduction for exhaustion of property. While respondent does not own the ore deposits, its right to mine and remove the ore and reduce it to possession and ownership is property within the meaning of the general provision. Obviously, as the process goes on, this property interest of the lessee in the mines is lessened from year to year, as the owner's property interest in the same mines is likewise lessened. There is an exhaustion of property in the one case as in the other. * * *"

If the cost of the hole is included in depreciation allowances as well as cost of machinery, tools, etc., which have a service life in no way connected with or dependent upon the length of time it takes to exhaust the mineral, then there is no expense whatever connected with an oil well left to be returned through depletion, and the regulation (Article 223) is robbed of any meaning, except as to the exploration of the property.

In Burnet v. Thompson Oil & Gas Co., 283 U. S. 301, the court said:

"It is clear that Congress intended that the lessee of an oil well should be entitled to a reasonable allowance for depletion based upon cost for March 1, 1913 value. It did not, however, attempt to prescribe a formula for ascertaining it, but expressly delegated that function to the Commissioner of Internal Revenue, who was to make rules and regulations to that end. Pursuant to this authority, regulations were made, which required the deduction of depletion theretofore sustained in ascertaining the capital remaining in any year recoverable by depletion deductions. * * *

"The decision in the Ludey case (United States v. Ludey, 274 U. S. 295) has been adopted in the later statutes as affecting sales of capital assets, but the provisions for annual depletion allowance has remained substantially unchanged. This in itself is persuasive evidence that Congress has approved the executive construction embodied in the regulations."

The long and consistent administrative construction, especially when it is, as here, clearly an admissible one and consistent with the purpose of the statute, should not be set aside unless plainly wrong. Universal Battery Co. v. United States, 281 U. S. 580; Fawcus Machine Co. v. United States, 282 U. S. 375; Williams v. Burnet, Commissioner, 59 Fed. (2) 357.

A consideration of this question leads to the conclusion that the elements calling for both depletion and depreciation are present in an oil well. The outlay for geological study and survey is directly connected with the location or discovery of the oil deposit, and would seem to be not subject in any way to depreciation, but should be allowed

under depletion when capitalized. So with the hole in the ground. It cannot be withdrawn or inventoried as having any independent value or resold as may be done with casing, tools or machinery. As the wages for labor and other expenses in connection with the transportation and work of a geologist in prospecting an oil field are a part of the cost of discovery or development so the wages for labor in drilling a well are such a part of the cost of discovery or development as are not susceptible of depreciation.

Section 204 of the Act of 1926, above set out, provides for "depletion and for depreciation of improvements", and goes on to leave the rules and regulations to be prescribed "by the commissioner with the approval of the secretary". Such rules and regulations have been prescribed and are apparently reasonable and just. Under these regulations, the cost of the drill hole of an oil well, and as it seems to us to be natural, is not subject to depreciation, but should be allowed for, especially when capitalized, under the head of depletion.

The Board of Tax Appeals rests its decision in the instant case on its decision in the case of A. T. Jergens Trust Co., 22 B. T. A. 551, where a similar question was presented; and the Court of Claims in the recent case of Dakota-Montana Oil Co. v. United States (decided July 5, 1932), has by a majority opinion reached the same conclusion as the Board. We are, however, of the opinion that the regulations are reasonable and having been in force for a long time they should be sustained, particularly where the taxpayer, as in this case, availed itself of the identical regulations to capitalize expenditures for intangibles, thus accepting the provision that such expenditures should be returned through allowances for depletion. The taxpayer cannot accept the benefits of the regulation and reject the accompanying obligation.

In conclusion we wish to say that if any of the expense of wages, hauling, etc. in connection with the casing, operating tools, machinery, etc. are included in the Commissioner's allowance for depletion it is our opinion that such expense should be depreciated. It is impossible for us to tell from the record the fact as to this question, but, as to allowances for all expense of putting down the drill hole the Commissioner was right in making such allowances

under the head of depletion. It follows that the decision of the Board of Tax Appeals must be

Reversed.

JUDGMENT—Filed and Entered October 8, 1932

UNITED STATES CIRCUIT COURT OF APPEALS, FOURTH CIRCUIT

No. 3316

DAVID BURNET, Commissioner of Internal Revenue, Petitioner,

vs.

PETROLEUM EXPLORATION, Respondent

On Petition to Review the Decision of the United States Board of Tax Appeals

This cause came on to be heard on the transcript of the record from the United States Board of Tax Appeals, and was argued by counsel.

On consideration whereof, It is now here ordered and adjudged by this Court that the decision of the said Board of Tax Appeals, in this cause, be, and the same is hereby, reversed; and that this cause be, and the same is hereby, remanded to the United States Board of Tax Appeals for further proceedings in accordance with the opinion of the Court filed herein.

October 8, 1932.

Elliott Northcott, U. S. Circuit Judge.

CLERK'S CERTIFICATE

UNITED STATES OF AMERICA.
Fourth Circuit, ss:

I, Claude M. Dean, Clerk of the United States Circuit Court of Appeals for the Fourth Circuit, do certify that the foregoing is a true copy of the record and proceedings in the therein entitled cause, as the same remain among

the records and files of the said Circuit Court of Appeals.

In testimony whereof I hereto set my hand and affix the seal of the said United States Circuit Court of Appeals for the Fourth Circuit, at Richmond, Virginia, this 10th day of October, A. D., 1932.

Claude M. Dean, Clerk U. S. Circuit Court of Appeals, Fourth Circuit. (Seal United States Circuit Court of Appeals, Fourth Circuit.)

(2557)

SUPREME COURT OF THE UNITED STATES

ORDER ALLOWING CERTIORARI—Filed November 14, 1932

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Fourth Circuit is granted, and the case is assigned for argument immediately following the hearing in case No. 434, United States vs. Dakota-Montana Oil Co.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

FILE COPY

Office Supreme Court, U. S.
FILED
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CHARLES ELMORE CROPLEY
CLERK

SUPREME COURT OF THE UNITED STATES.

OCTOBER TERM, 1932.

No. 448

PETROLEUM EXPLORATION, PETITIONER,

vs.

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT.

ROBERT ASH,
Counsel for Petitioner.

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SUPREME COURT OF THE UNITED STATES.

OCTOBER TERM, 1932.

No. 448

PETROLEUM EXPLORATION, PETITIONER,

vs.

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT.

Petroleum Exploration, by its attorney Robert Ash, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Fourth Circuit in the above entitled case rendered October 3, 1932. The case is not yet reported in the reporter systems but is reported at ¶ 1850 of the Prentice-Hall 1932 Federal Tax Service. It is also printed in full as an appendix to the petition for a writ of certiorari in No. 434, *The United States* v. *Dakota-Montana Oil Company.*

Question Presented.

Whether under the Revenue Act of 1926 the capitalized cost of drilling oil wells and of hauling and placing equipment in the wells is recoverable through depreciation as contended by the petitioner or through depletion as contended by the Commissioner of Internal Revenue.

Statute and Regulations Involved.

Revenue Act of 1926:

> "SEC. 234. (*a*) In computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:
>
> * * * * * * *
>
> "(7) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence;
>
> "(8) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee;"
>
> "SEC. 204(*c*)(2). In the case of oil and, gas wells the allowance for depletion shall be 27½

per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph."

Treasury Regulations 69 provide:

"ART. 221. Depletion in the Case of Oil and Gas Wells.—Under Section 204(*c*)(2), in the case of oil and gas wells, a taxpayer may deduct for depletion an amount equal to 27½ per cent of the gross income from the property during the taxable year, but such deduction shall not exceed 50 per cent of the net income of the taxpayer (computed without allowance for depletion) from the property. In no case shall the deduction computed under this paragraph be less than it would be if computed upon the basis of the cost of the property or its value at the basic date, as the case may be. In general, 'the property,' as the term is used in section 204(*c*)(2) and this article, refers to the separate tracts or leases of the taxpayer."

"ART. 223. Charges to Capital and to Expense in the Case of Oil and Gas Wells.—Such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of wells, building of pipe lines, and development of the property may at the option of the taxpayer be deducted as a development expense or charged to capital account returnable through depletion. If in exercising this option the taxpayer charges

these incidental expenses to capital account, in so far as such expense is represented by physical property it may be taken into account in determining a reasonable allowance for depreciation. * * *"

"ART. 225. Depreciation of Improvements in the Case of Oil and Gas Wells.—Both owners and lessees operating oil and/or gas properties will, in addition to and apart from the deduction allowable for depletion as hereinbefore provided, be permitted to deduct a reasonable allowance for depreciation of physical property, such as machinery, tools, equipment, pipes, etc., so far as not in conflict with the option exercistd by the taxpayer under article 223. The amount deductible on this account shall be such an amount based upon its cost or other basis equitably distributed over its useful life as will bring such property to its true salvage value when no longer useful for the purpose for which such property was acquired. Accordingly, where it can be shown to the satisfaction of the Commissioner that the reasonable expectation of the economic life of the oil or gas deposit with which the property is connected is shorter than the normal useful life of the physical property, the amount annually deductible for depreciation on such property may be based upon the length of life of the deposit. (See articles 161-170.)"

Statement.

The facts, which are fully stated at pages 30 to 32, inclusive, of the Record, are briefly summarized as follows:

During the years 1925, 1926 and 1927, Petroleum Exploration capitalized on its books of account the total cost of new productive oil wells drilled, such charges representing amounts paid for equipment put into the wells, amounts paid for drilling wells, amounts paid for freight and haulage of the equipment, and amounts paid for labor in installing the equipment in the wells. All the said wells had a life of more than one year.

Petroleum Exploration claimed that the entire cost of the wells, as stated above, was returnable to it through depreciation. The Commissioner of Internal Revenue held that the "intangible drilling costs," which include the amounts paid for drilling wells and the amounts paid for freight and haulage of the equipment and the amounts paid for labor in installing the equipment in the wells was not returnable through depreciation, but was recoverable through depletion. The Board of Tax Appeals decided in favor of Petroleum Exploration and adversely to the Commissioner of Internal Revenue. The Circuit Court of Appeals for the Fourth Circuit reversed the Board.

The taxpayer and the Commissioner are in agreement as to the formula to be applied in determining the amount of the deduction on account of the depreciation or depletion of this capital, whichever it is, and are in agreement as to the amount of the annual charge.

Specifications of Error.

1. The Circuit Court of Appeals erred in holding that the "intangible drilling costs" are returnable through depletion.

2. The Circuit Court of Appeals erred in not holding that the "intangible drilling costs" are returnable through depreciation.

3. The Circuit Court of Appeals erred in deciding in favor of the Commissioner of Internal Revenue.

Reasons for Granting the Writ.

1. In holding that "intangible drilling costs" are returnable through depletion instead of depreciation the decision below is in direct conflict with a recent decision of the Court of Claims. In *Dakota-Montana Oil Co.* v. *United States*, decided July 5, 1932, and reported in 59 Fed. (2d) 853, the Court of Claims held that under the Revenue Act of 1926 capitalized "intangible drilling costs" are not returnable by a depletion allowance and that they can only be returned through an allowance for depreciation. The opinion follows the Board of Tax Appeals in *A. T. Jergins Trust*, 22 B. T. A. 551, and is in direct conflict with the decision in the case at bar. The Government has filed a petition for certiorari in the *Dakota-Montana Oil Co.* case (No. 434), and cites as a basis for its petition the conflict with this case.

2. In the petition for certiorari in the *Dakota-Montana Oil Co.* case mentioned above the Government's brief states as a reason for its allowance the following:

> "2. The question presented is one of current general importance. The statutory provisions involved are in force in almost identical form in the 1928 and 1932 Revenue Acts. (Section

114(*b*)(3) of the Revenue Act of 1928; Section 114(*b*)(3) of the Revenue Act of 1932.) The question is presented in numerous cases now pending in the Bureau of Internal Revenue, the Board of Tax Appeals, and the Circuit Court of Appeals. The General Counsel of the Bureau of Internal Revenue states that it is present in cases before the Bureau involving claims for refund of approximately $5,000,000. The importance of the question from the taxpayer's point of view is that if expenses incurred in exploring and drilling oil and gas wells are subject to a depreciation allowance the taxpayer will normally receive the full amount of the expenses through such allowance, whereas due to the statutory limitation on the amount allowable for depletion the full amount of such expenses would not be returned through depletion. Thus the instant decision approves the taxpayer's deduction of the capitalized cost of drilling, in addition to the statutory depletion allowance of 27½ per centum of income. It is reasonable to suppose, therefore, that in all cases involving capitalized expenses arising out of the exploration and drilling of oil and gas wells taxpayers will claim that expenses such as those involved in this case are subject to a depreciation rather than a depletion allowance. The interpretation of these statutory provisions is, therefore, of importance to both taxpayers and to the Government. The existing conflict will make it impossible to administer the statutes with any certainty or consistency until the conflict is resolved by a decision of this Court."

Conclusion.

Wherefore it is respectfully submitted that this petition should be granted.

It is suggested that in the event the petition herein is granted that the case be advanced for argument and set immediately following No. 434, *The United States* v. *Dakota-Montana Oil Company.*

ROBERT ASH,
Munsey Building,
Washington, D. C.,
Attorney for Petitioner.

October, 1932.

FILE COPY

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CHARLES ELMORE CROPLEY
CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1932.

No. 448.

PETROLEUM EXPLORATION, INC.,
Petitioner,

vs.

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Fourth Circuit.

BRIEF FOR PETITIONER.

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IN THE

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No. 448.

PETROLEUM EXPLORATION, INC.,
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DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Fourth Circuit.

BRIEF FOR PETITIONER.

OPINION BELOW.

The opinion of the Board of Tax Appeals appears in the Record at pages 30 to 33, and is reported in 23 B. T. A. 890. The opinion of the Circuit Court of Appeals appears in the Record at pages 42 to 51, and is reported in 61 F. (2d) 273.

JURISDICTION.

The judgment of the Circuit Court of Appeals was entered October 8, 1932. The petition for certiorari was

filed October 12, 1932, and granted November 14, 1932. Jurisdiction is conferred upon this Court by Section 240(a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED.

Whether, under the Revenue Act of 1926, the capitalized cost of drilling oil wells and of hauling and placing equipment in the wells is recoverable through depreciation as contended by the petitioner or through depletion as contended by the Commissioner of Internal Revenue.

The Board of Tax Appeals held that the entire cost of drilling the wells and of hauling and placing equipment was recoverable through depreciation. The Circuit Court of Appeals held that the cost of hauling and placing equipment was recoverable through depreciation, but that the cost of drilling the wells was recoverable through depletion.

STATUTE AND REGULATIONS INVOLVED.

Revenue Act of 1926:

> "SEC. 234. (*a*) In computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:
>
> * * * * * * * * *
>
> "(7) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence;
>
> "(8) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. In the case

of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee;"

"SEC. 204(*c*)(2). In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph."

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"ART. 221. Depletion in the Case of Oil and Gas Wells.—Under Section 204(*c*)(2), in the case of oil and gas wells, a taxpayer may deduct for depletion an amount equal to 27½ per cent of the gross income from the property during the taxable year, but such deduction shall not exceed 50 per cent of the net income of the taxpayer (computed without allowance for depletion) from the property. In no case shall the deduction computed under this paragraph be less than it would be if computed upon the basis of the cost of the property or its value at the basic date, as the case may be. In general, 'the property,' as the term is used in section 204(*c*)(2) and this article, refers to the separate tracts or leases of the taxpayer."

"ART. 223. Charges to Capital and to Expense in the Case of Oil and Gas Wells.—Such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of wells, building of pipe lines, and development of the property may at the option of the taxpayer be deducted as a development expense or charged to capital account returnable through depletion. If in exercising this option the taxpayer charges these incidental expenses to capital account, in so far as such expense is represented by physical property it may be taken into account in determining a reasonable allowance for depreciation. * * *"

"ART. 225. Depreciation of Improvements in the Case of Oil and Gas Wells.—Both owners and lessees operating oil and/or gas properties will, in addition to and apart from the deduction allowable for depletion as hereinbefore provided, be permitted to deduct a reasonable allowance for depreciation of physical property, such as machinery, tools, equipment, pipes, etc., so far as not in conflict with the option exercised by the taxpayer under article 223. The amount deductible on this account shall be such an amount based upon its cost or other basis equitably distributed over its useful life as will bring such property to its true salvage value when no longer useful for the purpose for which such property was acquired. Accordingly, where it can be shown to the satisfaction of the Commissioner that the reasonable expectation of the economic life of the oil or gas deposit with which the property is connected is shorter than the normal useful life of the physical property, the amount annually deductible for depreciation on such property may be based upon the length of life of the deposit. (See articles 161-170.)"

STATEMENT OF THE CASE.

This case involves deficiencies in income tax for the years 1925, 1926 and 1927 in the amounts of $700.81, $996.09 and $1,047.23, respectively. Deficiences in larger amounts asserted in the "notices of deficiency" (R. 9, 23) are due to other adjustments to income which are not contested in this action.

Two appeals were filed with the Board of Tax Appeals, Docket No. 43480 involving the years 1925 and 1926 and Docket No. 49339 involving 1927. The actions were consolidated and heard and disposed of on one record and by one opinion.

The facts, which are fully stated at pages 30 to 32 of the Record, are briefly as follows:

Petitioner is a Maine corporation with its principal office at Sistersville, West Virginia (R. 30).

On December 31, 1924, its undepreciated investment in equipment in oil wells amounted to $475,975.02.

During 1925, 1926 and 1927 the petitioner capitalized on its books of account the total cost of new productive oil wells drilled, such charges representing amounts paid for equipment put into the wells, amounts paid to drilling contractors for drilling the wells, amounts paid for freight and haulage of the equipment, and amounts paid for labor in installing the equipment in the wells, as follows:

Year	Cost of equipment	Cost of drilling wells, hauling and placing equipment	Total cost of completed producing wells
1925	$121,303.03	$49,640.17	$170,943.20
1926	15,882.88	52,994.14	68,887.02
1927	56,626.31	2,659.26	59,285.57

The productive life of all producing wells, the total cost of which was capitalized as shown above, is more than one year.

Depreciation has been claimed by the petitioner and allowed by the Commissioner at a unit production rate based on the lengths of life of the oil deposits.

The petitioner, in making its computation of depreciation, added the total cost of completed wells, including equipment, drilling, hauling and placing the equipment, to its depreciation schedules, no part of the cost of the wells being added to the cost depletion schedules.

The Commissioner in making his computation of depreciation has added to his depreciation schedules the cost of the equipment added each year as shown in the above table, but has not added the cost of drilling wells, hauling and placing the equipment.

Instead, the cost of drilling wells, hauling and placing equipment, as shown in the above table, has been added to the cost depletion schedules by the Commissioner; but de-

pletion has been allowed on a statutory percentage basis (27½ per cent of gross income, not to exceed 50 per cent of net income) and is not based on cost.

The Board of Tax Appeals approved the Petitioner's method and redetermined the amount of the deficiencies accordingly, on the authority of its earlier decision in *A. T. Jergins Trust*, 22 B. T. A. 551.

The Circuit Court of Appeals (R. 42) decided that the freight and haulage of the equipment and the labor for installing it was returnable through depreciation but that the cost of drilling the wells was returnable through depletion. In accordance with the opinion the case was remanded to the Board of Tax Appeals for further proceedings in accordance therewith.

SUMMARY OF ARGUMENT.

In the administration of the earlier taxing acts the Commissioner of Internal Revenue by regulation gave the option of charging drilling costs to expense or of capitalizing and returning them through depletion. The physical property in the wells was returnable through depreciation. The Board of Tax Appeals held (*Old Farmers Oil Co.*, 12 B. T. A. 203) that the option given by the regulations is invalid as the Commissioner has no power to hold that a purely capital item is a business expense. The Board's ruling expresses a fundamental rule of tax law and of accounting. It results in records which clearly reflect income as required by the taxing acts.

The Circuit Court of Appeals, however, has held that as the taxpayer made the election under the regulations it is bound by the requirement of the regulations that the costs be returned through depletion.

The regulation was of no financial importance until the 1926 Act when the allowance for depletion was fixed at a flat 27½ per cent rate. As a consequence the taxpayer who expenses drilling costs deducts them in the year in-

curred and in addition gets the 27½ per cent depletion deduction. The taxpayer who capitalizes the expenses is allowed by the regulations only the 27½ per cent depletion deduction. The point was litigated as soon as it could be brought to the Board of Tax Appeals which has held in several cases, beginning with *A. T. Jergins Trust,* 22 B. T. A. 551, that the entire costs here involved are returnable through depreciation.

A completed oil well is a physical thing which requires the use of a vast and varied amount of material and labor, much of which has no salvage value.

The Commissioner has always followed established accounting practice by including in the cost of buildings not only the material therein but the cost of the labor of erection. Likewise machinery and other assets are capitalized at the total cost of acquisition, transporting and erecting. There is no reason why a different rule should be applied to oil wells as all the money is expended to construct a completed well.

It is true that the drill hole becomes valueless with the exhaustion of the mineral, but so do the foundations for the machinery, the "cellar," etc. Often the casing cannot be "pulled" and salvaged.

It is impossible to segregate the drilling costs from the cost of installing the casing.

The taxing acts contain a general proviso permitting the deduction of "a reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence." In addition the statute has a special provision "In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion, and *for depreciation of improvements.*"

If a word has a judicially settled meaning it must be presumed that it was used in that sense by Congress. "Improvements" as used in mining statutes means an ar-

tificial change of the physical condition of the earth on or near a mining claim as to evidence a design to discover mineral therein or to facilitate its extraction. The act, therefore, specifically provides for the depreciation of an oil well. The legislative history indicates this was the intent of Congress.

The meaning of the words "depreciation" and "depletion" was settled by *United States v. Ludey*, 274 U. S. 295, and depletion applies only to the mineral.

ARGUMENT.

Cost of Drilling Oil Wells is Capital Expenditure and Not Expense.

During the many years that depletion of oil and gas wells has been allowed the Commissioner of Internal Revenue by regulation has held that the cost of wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of wells, building of pipe lines and development of the property, could, at the option of the taxpayer, be deducted as expense in the year in which incurred or capitalized. See Art. 170, Regulations 33 (1917 Act); Art. 223 of Regulations 45, 62, 65, 69 (1918, 1921, 1924 and 1926 Acts); and Art. 243, Regulations 74 (1928 Act). If the said costs were capitalized the Commissioner required that they be returned through depletion. The cost of physical property having a salvage value was returnable through depreciation.

While this case is not concerned with the situation where the costs were deducted as expense it is interesting to note that the Board of Tax Appeals has held the regulation invalid:

> "Before discussing this regulation (Art. 223, Reg. 45), it is expedient to point out that what is properly a capital investment is not and cannot be an ordinary and necessary expense and that the reverse is

> equally true. The Revenue Act of 1918 conferred no authority on the Commissioner to arbitrarily determine by regulation or otherwise that a purely capital item was a business expense. Compare *Union Metal Manufacturing Co.*, 1 B. T. A. 395; *Union Collieries Co.*, 3 B. T. A. 540; *Boyne City Lumber Co.*, 7 B. T. A. 36. Much less could he authorize a taxpayer to elect whether he will deduct from gross income an expenditure made for a purely capital purpose as an ordinary and necessary expense. * * *" (*Old Farmers Oil Co.*, 12 B. T. A. 203, 217.)

The Commissioner acquiesced in the Old Farmers Oil Co. case, C. B. VII-2, p. 30.

The foregoing quotation expresses a fundamental rule of tax law. Likewise it expresses a fundamental rule of accounting. If this taxpayer had expensed and not capitalized the amounts here involved its books would not have reflected actual facts. Income would be distorted and assets with a life of approximately fifteen years would not be shown as assets.

The taxing acts have always required that taxpayers' records be so kept as to clearly reflect income. The regulation results in a failure to clearly reflect income and is beyond the Commissioner's power.

The Circuit Court held, in the case at bar, that because this taxpayer has sought to keep its books in such a manner that they reflect the true facts it is to be placed at a disadvantage as compared with a taxpayer who charges capital items to expense. The Court states (R. 47):

> "Here the taxpayer was given the option under the provisions of Article 223 of Regulations 69 to either charge the expenditures in question to development expense or charge them to capital account *returnable through depletion.* (Italics ours.) This option was exercised by the taxpayer by charging the expenditures to capital account, and by so acting the taxpayer must have done so with the full knowledge that such sums so charged must come back through depletion and not depreciation. This is the plain provision of the Regulation."

The option provided in Article 223 had no financial effect on oil operators who capitalized drilling costs until the enactment of the Revenue Act of 1926. In prior revenue acts both depreciation and depletion were returnable on a "unit of production" basis so it made no difference whether the drilling costs were added to the depreciable base or depletable base. By either method the taxpayer recovered his cost. Due to the uncertainty of administration of the "discovery" sections of the law, Congress in the 1926 Act (which applied to 1925 and subsequent years) provided for an arbitrary depletion deduction of 27½ per cent of the gross income from oils and gas wells. As a consequence the taxpayer who expenses drilling costs gets that deduction in the year the expenses are incurred and in addition gets the 27½ per cent depletion deduction. On the other hand, the taxpayer who keeps books that reflect true facts secures, under the Commissioner's ruling, only the 27½ per cent deduction and can never recover the drilling costs.

The interpretation of the Commissioner on the point involved was litigated as soon as it was possible to reach the Board of Tax Appeals. The first decision is *A. T. Jergins Trust*, 22 B. T. A. 551, wherein it is stated (p. 562):

> "The final contention of petitioner is that respondent erred in adding its drilling development expenses to the amounts recoverable through depletion. Petitioner has waived its contention that these costs are proper subjects for annual deductions and apparently concedes that they should be capitalized. We believe that his is the proper solution of the problem. Cf. *Consolidated Mutual Oil Co.*, 2 B. T. A. 1067, *Old Farmers' Oil Co.*, 12 B. T. A. 293. Both parties agree that these capital expenditures are returnable to petitioner during the life of its lease and they differ only as to the character of the deduction. Respondent has allowed it as depletion, while petitioner claims it as depreciation. Respondent has added these expenditures to amounts recoverable through depletion and has thus determined a larger depletion unit. Ordinarily, where

there is no difference as to the rate, it would become immaterial whether the capital cost was recovered as depreciation or as depletion. But section 234 (a) (8) of the Revenue Act of 1924 as restricted by section 204 (c) of the same act places certain limitations on the deduction for depletion while the deduction for depreciation is subject to no such restrictions. In the present case the restriction operates to deny to petitioner the full amount of the deduction for depletion to which it would otherwise be entitled. Under these conditions it becomes necessary to discuss the character of the deduction. Section 234 (a) (9) of the Revenue Act of 1921 and section 234 (a) (8) of the Revenue Act of 1924 permit the deduction in cases such as this of 'a reasonable allowance for depletion and for depreciation of improvements * * *.' As we understand the stipulation, the amounts in controversy were expended in drilling wells and in operations preparatory and relating to such drilling, all of which would constitute a part of the cost of the structure recoverable through depreciation. On the other hand, the concept of the term 'depletion' is the exhaustion of the mineral content of a mine or an oil well. *United States v. Ludey*, 274 U. S. 295. The precise wording of the statute indicates clearly that Congress had in mind the distinction between the exhaustion of the natural resources and the recovery of the capital invested in the improvements necessary to work the property. It can not be seriously contended that the exhaustion of petitioner's investment in preparing for and in drilling its wells constitutes any part of the exhaustion of its oil reserves.

"The Commissioner relies upon article 223 of Regulations 62 which provides:

> 'Such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of wells, building of pipe lines, and development of the property may at the option of the taxpayer be deducted as a development expense or charged to the capital account returnable through depletion. *If*

in exercising this option the taxpayer charges these incidental expenses to capital account, in so far as such expense is represented by physical property it may be taken into account in determining a reasonable allowance for depreciation. * * *'
(Italics supplied.)

"If this regulation is susceptible of the construction which has been placed upon it in this case, it is in conflict with the provisions of the statute, which allows improvements to be depreciated. It seems to us, however, that the regulation has not been properly applied in this case. The construction used in computing the deficiency was that tangible assets which go upon the property, such as lumber, cement, casing, tubing, etc., are all charges that 'are represented by physical property while other costs were not.' The cost of labor for erecting the derrick or drilling the well, the fuel used in such operation, the cost of hauling such materials are all 'represented by physical property.' The Commissioner in his brief recognizes that such is the case and now urges that we sustain his action upon the ground that the stipulated facts are insufficient to show what part of the amount disallowed were represented by physical property. The stipulation shows that the Commissioner has allowed as the cost of improvements (the word used in the statute) only the amounts expended for physical equipment and has refused to treat as cost of improvements amounts expended for wages, fuel, repairs and hauling 'in connection with development and drilling.' This terminology excludes the idea that any part of such amount was expended in discovery or exploration work or in operating the leased property. Amounts expended in development and drilling operations convey to us the impression of expenditures for improvement of the property upon which the statute permits the taxpayer to deduct depreciation. The adjustment of taxable income will be accomplished by allowing as depreciation the amounts previously treated as depletion allowances upon these expenditures."

The Jergins decision was followed by the Board in the cause at bar; *Ziegler, et al.*, 23 B. T. A. 1091; *P-M-K. Petroleum Co.*, 24 B. T. A. 360; *Twin Bell Oil Syndicate*, 26 B. T. A. 172; and by the Court of Claims in *Dakota-Montana Oil Co. v. United States*, 59 F. (2d) 853, now pending before this Court (No. 434). The Jergins case was disposed of by the Circuit Court of Appeals for the Ninth Circuit on other grounds and is now pending before this Court on petition for a writ of certiorari (No. 541).

It should be realized that a completed oil well is a physical thing which can be seen and touched. It performs a useful function. It consists of an aggregation of physical things such as pipes, casings, valves, pumps, tanks, and various other articles of metal and lumber. In accomplishing the completion of the oil well heavy machinery must be transported to the site, a boiler and engine must be set up, and a derrick of wood or steel must be erected for handling the tools and casing. This must be equipped with drilling machinery. There must be surface excavation, the building of foundations for machinery, and other similar work before drilling begins. Where high pressures are expected there is constructed an elaborate concrete "cellar" through which the drilling is carried on. The cellar foundations and many other component parts of the well have no salvage value and cannot be moved. Large supplies of fuel and water must be provided and the transportation of fuel, water, other supplies, casings and equipment may be one of the important items of expenditure. Both skilled and unskilled labor are required for the actual drilling operation. The labor is expended partly in making the hole and partly in the installation of the casing and other equipment. When the hole has reached a depth of a few hundred feet at large diameter it is lined with steel casing which is usually cemented into place at the bottom. Large quantities of cement are used, especially if water or some other difficult condition is encountered. Drilling

then proceeds through the casing several hundred feet deeper, when a second casing of smaller diameter is placed inside the first reaching from the surface to the bottom of the hole, and drilling then goes on. Often a well has several concentric casings of which only the innermost and smallest reaches to the ultimate depth. If the well is a producer, such as those here involved, there is a further use of labor in making it ready to flow or to be pumped, including the construction of flow lines and flow tanks, the installation of pumps, etc.

Without the labor, the freight, and all such things for which the costs above enumerated were incurred, it would be impossible to produce a completed oil well which is the ultimate physical object here involved.

The Commissioner has permitted the physical property with which the wells were equipped to be capitalized and returned through depreciation. He has insisted, however, that the many other costs of drilling wells, hauling and placing equipment, etc., as enumerated above, must be considered as returnable through depletion. The Circuit Court of Appeals held that the cost of putting down the drill hole is returnable through depletion, but the other costs are returnable through depreciation.

In the administration of the taxing acts the Commissioner has always followed the established accounting practice that the cost of any asset includes the cost of transporting and erecting the material. Thus a building is capitalized at the cost of the completed structure, not merely the cost of the material entering into the building. It is well known that the labor of constructing a building usually exceeds the cost of the material therein. Likewise it has always been the practice to capitalize machinery and other assets at the total cost of acquisition, transporting and erecting. To do otherwise would not reflect true facts. There is no possible reason why a different rule should be applied to an oil well. All of the money is expended to

construct the completed well. This applies to the drill hole as well as the other parts of the well. The drill hole is put down for the sole purpose of installing the casing and machinery and bears the same relation to the completed well as does the excavation and foundation to a building. It is true that the drill hole becomes valueless with the exhaustion of the mineral, but so do the excavations and foundations for the machinery, the "cellar", etc. In fact, the casing often cannot be salvaged because it is so securely cemented in the well that it cannot be "pulled." In other words, the many items that go to make up an oil well cannot be segregated and there is no reason why an attempt should be made to segregate some of them for purposes of depreciation. The realities of the situation are such that the labor of making the hole and of installing the casing, is so interrelated that it cannot be segregated as the Circuit Court of Appeals suggests it should be.

Statute Specifically Provides for Depreciation of Improvements.

The petitioner contends that the situation here presented is specifically covered by the statute and that the items here involved must be returned through depreciation.

The various taxing acts have provided that all business concerns are entitled to deduct from income "a reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence." The foregoing is a general provision. In construing the earlier taxing acts this Court held (*Von Baumbach v. Sargent Land Co.*, 242 U. S. 503) that "depreciation" did not mean "depletion." In the 1918 Act there was inserted the language which is in the act here involved as follows:

> "In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion, and *for depreciation of improvements* * * *"

The allowance for depreciation of improvements is something in addition to the usual "reasonable allowance for the exhaustion, wear and tear of property" and applies only to mines, oil and gas wells, other natural deposits and timber.

It is established that if a word has a judicially settled meaning it must be presumed it was used in that sense by Congress. *U. S. v. Merriam*, 263 U. S. 179, 187; *Kepner v. U. S.*, 195 U. S. 100, 124; *The Abbotsford*, 98 U. S. 440, 444.

It must follow, therefore, that when Congress inserted the special proviso with reference to the deduction for depreciation on improvements it used the word "improvement" as it is used in the mining industry. In the "Glossary of Mining and Mineral Industry," published by the United States Bureau of Mines, it is stated:

> "*Improvement.* As used in the mining statutes, is an artificial change of the physical condition of the earth upon or reasonably near a mining claim as to evidence a design to discover mineral therein, or to facilitate its extraction. It must be reasonably permanent in character (*Frederick v. Klauser*, 32 Oregon, p. 116). See *also* Labor and Improvement." (p. 357.)
>
> "*Labor and Improvements.* Labor performed or improvements made for development in such manner as to facilitate the extraction of the metals, though such labor and improvements may not be on the particular location itself (Smelting Co. v. Kemp, 104 United States, p. 651 (636); Jackson v. Robey, 109 United States, p. 444; Justice Min. Co. v. Barclay, 82 Fed. Rept., p. 560; Anvil Hydraulic and Drainage Co. v. Code, 182 Fed. Rept., p. 206)." (p. 383.)

Reference to the decisions of this Court cited in the Glossary shows that the word "improvement" as above defined is the definition given by this court.

In fact in the common use of the word even a water well is understood to be an improvement. It often happens that

a good water well is one of the most important of all the "improvements" contributing to the value of a farm.

That Congress clearly had in mind that the expenditures here involved should be recoverable through depreciation rather than through depletion is clearly shown by the legislative history of the provision. Prior to the Revenue Act of 1918 there was no provision in the statute similar to the provision here involved. In listing the deductions allowed from gross income in the Revenue Act of 1918, however, Congress inserted the identical language which is still in the statute, namely, adding after "In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion" the following "and for depreciation of improvements * * *." In explaining this addition to the Revenue Act of 1918 the Ways and Means Committee of the House of Representatives in reporting the bill stated (p. 10):

> "The depletion provision of existing law does not grant an allowance for cost of development. In the case of mines, oil and gas wells, such an allowance seems only equitable and fair and the bill provides that a reasonable allowance in such cases be allowed for depreciation of improvements. * * *"

In view of the history of the provision and the judicially settled meaning of the word "improvements" it would seem that the only possible construction to be placed on the provision is that this taxpayer is entitled to depreciation on the entire "improvements" which include the drilling costs as well as the actual equipment itself.

Depletion and Depreciation Have Entirely Different Meanings. Depreciation is the Only Deduction Applicable in This Case.

The word "depreciation" comes from the Latin word "depretaire" meaning to lessen in price or value. The

word "depletion" comes from the Latin word "deplere" meaning to empty or exhaust.

That the words have separate and distinct meanings is settled by *United States v. Ludey*, 274 U. S. 295, in which the court explained the difference between the two words. At page 300 the court said:

> "* * * The depreciation charge permitted as a deduction from the gross income in determining the taxable income of a business for any year represents the reduction, during the year, of the capital assets through wear and tear of the plant used. The amount of the allowance for depreciation is the sum which should be set aside for the taxable year, in order that, at the end of the useful life of the plant in the business, the aggregate of the sums set aside will (with the salvage value) suffice to provide an amount equal to the original cost. The theory underlying this allowance for depreciation is that by using up the plant, a gradual sale is made of it. The depreciation charge is the measure of the cost of the part which has been sold. * * *."

On page 302 the Court said:

> "The depletion charge permitted as a deduction from the gross income in determining the taxable income of mines for any year represents the reduction in the mineral contents of the reserves from which the product is taken. The reserves are recognized as wasting assets. The depletion effected by operation is likened to the using up of raw material in making the product of a manufacturing establishment. As the cost of the raw material must be deducted from the gross income before the net income can be determined, so the estimated cost of the part of the reserve used up is allowed. The fact that the reserve is hidden from sight presents difficulties in making an estimate of the amount of the deposits. The actual quantity can rarely be measured. It must be approximated. And because the quantity originally in the reserve is not actually known, the percentage of the whole withdrawn

> in any year, and hence the appropriate depletion charge, is necessarily a rough estimate. But Congress concluded, in the light of experience, that it was better to act upon a rough estimate than to ignore the fact of depletion."

It seems clear that the distinction between "depletion" and "depreciation" is established and that the depletion deduction can apply only to the exhaustion of the mineral. The Commissioner, however, seeks to have the depletion deduction also cover the facilities for removing the mineral. This, it seems to us, is clearly erroneous because such facilities are the very "improvements" for which the statute provides an allowance for depreciation.

The words "oil and gas wells" when used in Section 234(a)(8) obviously refer to the natural deposit. This is apparent because Section 204(c)(2) provides that "in the case of oil and gas wells" the depletion allowance shall be 27½ per cent of the gross income. The term "depletion" is intended to apply only to the mineral itself, while the term "depreciation" is intended to apply to every other element or improvement making up the completed oil well. This is further indicated by the use of "other natural deposits and timber" after "mines, oil and gas wells" when the reasonable allowance for depletion is provided by Section 234(a)(8).

CONCLUSION.

In view of the foregoing the Board of Tax Appeals should be affirmed.

Robert Ash,
Attorney for Petitioner,
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Washington, D. C.

December, 1932.

FILE COPY

No. 448

In the Supreme Court of the United States

OCTOBER TERM, 1932

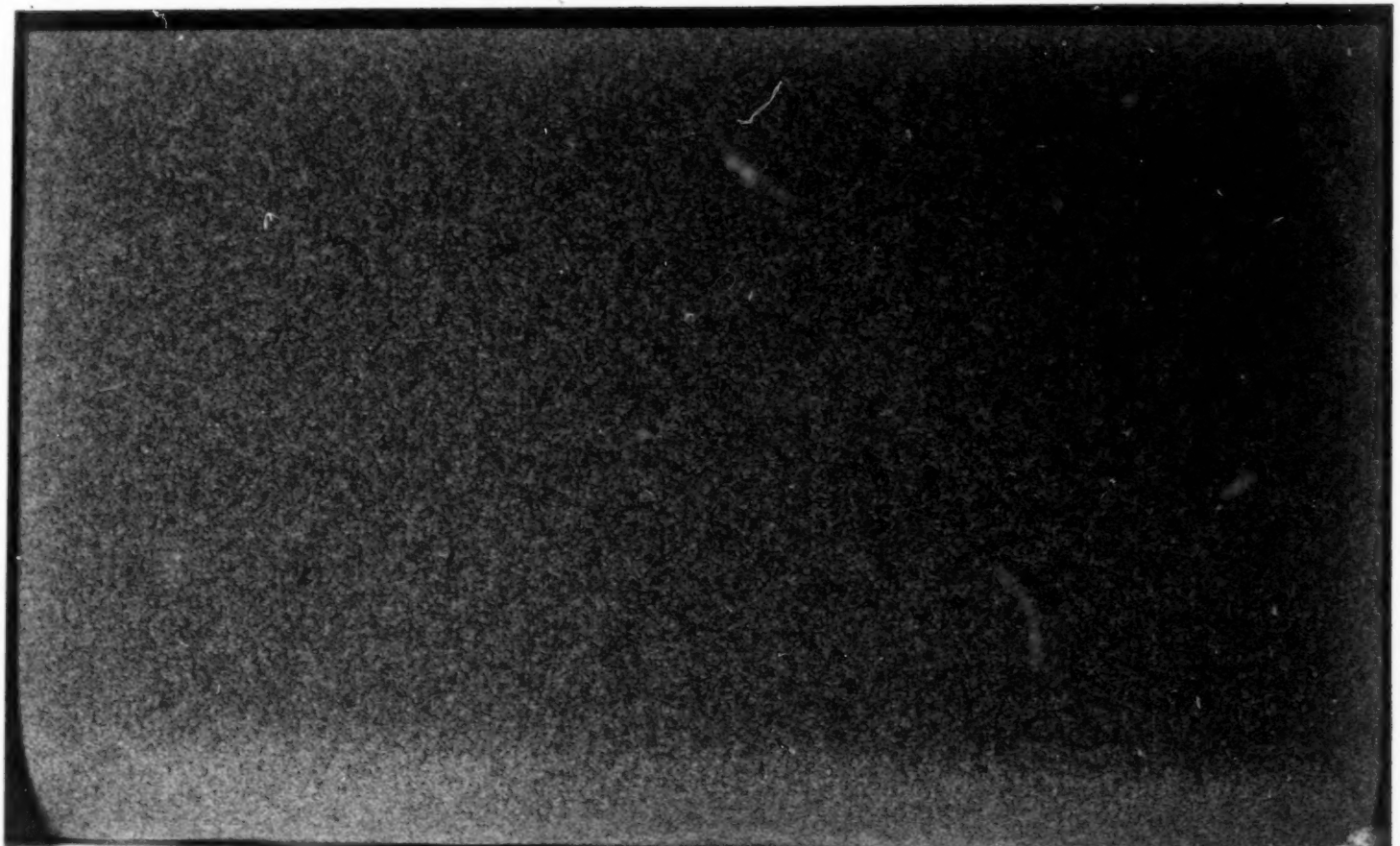
PETROLEUM EXPLORATION, PETITIONER

v.

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT



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In the Supreme Court of the United States

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MEMORANDUM FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 29–33) is reported in 23 B. T. A. 890. The opinion of the Circuit Court of Appeals (R. 42) is not yet reported.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered October 8, 1932. (R. 51.) The petition for a writ of certiorari was filed October 12.

1932. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

DISCUSSION

The question presented in this case, whether capitalized expenditures by the petitioner for drilling costs in connection with oil wells are to be returned to the taxpayer through depletion or depreciation, under the applicable Revenue Act, is one of the questions involved in *United States, Petitioner,* v. *Dakota-Montana Oil Company,* No. 434, October Term, 1932, now pending on petition for certiorari. In its petition for certiorari in that case the Government relied on a conflict between the decision of the Court of Claims therein and the decision of the Circuit Court of Appeals in this case.

The Circuit Court of Appeals held that, under Treasury Regulations which had received legislative approval, such costs when capitalized were returnable only through depletion and expressly refused to follow the decision of the Court of Claims in the *Dakota-Montana Oil Company* case that such capitalized costs were to be returned through depreciation. In its petition for certiorari in the latter case the Government also asserted that the question was one of general importance and that review by this Court to resolve the conflict was necessary. Under these circumstances, we do not oppose the granting of the instant petition.

If the petitions in No. 434 and in this case are granted, we concur in the petitioner's suggestion that this case should be advanced for argument immediately after No. 434.

Respectfully submitted.

THOMAS D. THACHER.
Solicitor General.

OCTOBER, 1932.

U. S. GOVERNMENT PRINTING OFFICE : 1932

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BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 29–33) is reported in 23 B. T. A. 890. The opinion of the Circuit Court of Appeals (R. 42) is reported in 61 F. (2d) 273.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered October 8, 1932. (R. 51.) The petition for a writ of certiorari was filed October 12, 1932, and was granted November 14, 1932. The

jurisdiction of this Court rests on Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether, under the Revenue Act of 1926, capitalized expenditures for drilling oil wells and for hauling and placing equipment may be added to the cost of physical property subject to a depreciation allowance or are returnable to the taxpayer through a depletion allowance.

STATUTES AND REGULATIONS INVOLVED

These will be found in Appendix A of petitioner's brief in No. 434, *United States* v. *Dakota-Montana Oil Co.*

STATEMENT

The facts as found by the Board of Tax Appeals, upon a stipulation, are in substance as follows:

Petitioner is a Maine corporation with its principal office at Sistersville, West Virginia. (R. 30.) On December 31, 1924, its undepreciated investment in equipment in oil wells amounted to $475,975.02. (R. 31.) The taxes involved are those for the years 1925, 1926, and 1927. (R. 30.)[1]

During 1925, 1926, and 1927 petitioner capitalized on its books the total cost of new productive oil wells drilled, such charges representing amounts paid for equipment put into the wells, amounts paid to drilling contractors for drilling the wells,

[1] The Revenue Act of 1926 applies to the year 1925, § 286.

amounts paid for freight and haulage of the equipment, and amounts paid for labor in installing the equipment in the wells, as set out in tabular statement on page 31 of the record. The productive life of these wells is greater than one year. (R. 31.)

Depreciation was claimed by petitioner and allowed by the Commissioner at the unit production rate, based on the life of the oil deposits. (R. 31.)

The Commissioner, in making his computation of depreciation, added to the depreciation schedules the cost of equipment added each year, but did not add the cost of drilling wells, hauling and placing the equipment. (R. 31.) He added the cost of drilling wells, hauling and placing the equipment to the cost-depletion schedules; but depletion has been allowed on a statutory percentage basis (27½ per cent of gross income, not to exceed 50 per cent of net income), and is not based on cost. (R. 31.)

Petitioner, in making its computation of depreciation, added the total cost of completed wells, including equipment, drilling, hauling and placing the equipment, to its depreciation schedules, no part of the cost of the wells being added to the cost-depletion schedules. The amounts of increase in the depreciation allowances and of decrease in depletion allowance, if petitioner's method of determining the allowances be adopted, are shown on record page 32.

The Board sustained petitioner's contention that it was entitled to add to its property subject to de-

preciation the cost of drilling, hauling and placing equipment and thus to receive a depreciation allowance thereon, and redetermined the amount of the deficiencies accordingly. (R. 33.) The Circuit Court of Appeals reversed the Board.

ARGUMENT

This case involves the right of the petitioner under Section 234 (a) (8) of the Revenue Act of 1926, and Regulations 69, Articles 223 and 225 thereunder, to treat capitalized costs of drilling oil wells, hauling and placing equipment as property upon which a depreciation allowance may be made in addition to the arbitrary depletion allowance under Section 204 (c) (2) of the Revenue Act of 1926. The question thus presented is in all respects similar to the question presented in No. 434, *United States* v. *Dakota-Montana Oil Co.*, except that in the instant case the expenses which the petitioner seeks to have returned through depreciation include expenses for hauling and placing equipment but do not include expenditures for preliminary development. It has been assumed throughout this case that the expenses for hauling and placing equipment were expenses in connection with the hauling and placing of drilling equipment, and hence the expense was a part of the cost of drilling the wells. Accordingly, the proper treatment of these expenses depends upon the same considerations which are dealt with in Point I of the petitioner's brief in No. 434. As the matter has

been fully discussed therein, we respectfully refer to our argument in Point I of that brief as our argument in this case.

CONCLUSION

The decision of the court below was correct and should be affirmed.

Respectfully submitted.

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JANUARY, 1933.

U. S. GOVERNMENT PRINTING OFFICE: 1933

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IN THE

Supreme Court of the United States

October Term, 1932

No. 448

PETROLEUM EXPLORATION, Inc., *Petitioner,*

against

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF OF AMERADA CORPORATION AS *AMICUS CURIAE*

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IN THE

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October Term, 1932

No. 448

PETROLEUM EXPLORATION, INC.,
Petitioner,

against

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF OF AMERADA CORPORATION AS *AMICUS CURIAE.*

Preliminary Statement.

Amerada Corporation and its affiliates have claims for refund pending before the Commissioner of Internal Revenue involving the same question presented in the above entitled case. In all of the essential facts, except of course, the exact figures, the facts with respect to the Amerada claims are like the facts involved in this case, and a decision of this Court upon the questions of law involved will necessarily govern the action of the Commissioner of Internal Revenue upon such claims. It follows, therefore, that the Amerada Corporation is vitally interested in the decision

in the present case and proposes in this brief to show to this Court that the decision of the United States Circuit Court of Appeals for the Fourth Circuit was in error and that the decision of the Board of Tax Appeals, which was the Court of incidence in this case, was correct.

Opinion Below.

The opinion of the Board of Tax Appeals is reported in 23 B. T. A. 890. The opinion of the Circuit Court of Appeals is reported in 61 Fed. (2d), 273.

Jurisdiction, Statement of Fact and Statement of the Question Presented.

We adopt the statement of counsel for the petitioner as to the jurisdiction, the facts involved and the question presented to this Court. We will not burden the Court with an extended reiteration of them here.

Summary of Argument.

1. Sec. 234 (a) (8) of the Revenue Act of 1926 specifically provides for the recovery of capitalized drilling costs through an allowance for depreciation.

2. That Congress intended that improvements on mineral properties, including capitalized drilling costs, should be recovered through an allowance for depreciation is of public record.

3. The attempt of the respondent to require capitalized drilling costs to be recovered through an allowance for depletion is a perversion of the expressed mandate of the

Statute requiring that the Commissioner of Internal Revenue grant "a reasonable allowance for depletion".

4. Depletion and depreciation have come to have distinct and separate meanings in tax statutes and there is no basis for confusing the application thereof.

ARGUMENT.

I.

The statute prescribes return of capitalized drilling costs through depreciation.

Section 234 (a) (8) of the Revenue Act of 1926 (44 Stat. 42) provides as follows:

> "In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary."

It is established that if a word has a judicially settled meaning it must be presumed that it was used in that sense in the Statute in which it is found. (*U. S.* v. *Merriam*, 263 U. S. 179, 187; *Kepner* v. *U. S.*, 195 U. S. 100, 124; *The Abbotsford*, 98 U. S. 440, 444. In the "Glossary of Mining and Mineral Industry", published by the United States Bureau of Mines, the Bureau defines the word "improvement" in the following terms:

> "*Improvement.* As used in the mining statutes is an artificial change of the physical condition of the

> earth upon or reasonably near a mining claim as to evidence a design to discover mineral therein, or to facilitate its extraction. It must be reasonably permanent in character (*Frederick* v. *Klauser*, 32 Oregon 116."

Thus it appears that the term "improvement" has a well established definition in connection with the mining and mineral industry in language that is not ambiguous or susceptible of misinterpretation. It follows that when Congress used that word in the portion of the Statute above which deals with the mining industry, it must have used the word in its well accepted meaning and that therefore improvements, as so defined, are to be recovered through an allowance for depreciation.

II.

It is of public record that Congress intended that drilling costs incurred in improving oil fields are to be recovered through an allowance for depreciation.

The Revenue Act of 1918 [40 Stat. 1057], Sec. 214 (a) (10), pages 1066-1067, provided as follows:

> (a) "That in computing net income there shall be allowed as deductions:
>
> • • • • • • • •
>
> (10) "In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable al-

> lowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case * * *."

The phrase "and for depreciation of improvements" does not appear in the earlier Revenue Acts in connection with the depletion allowance and this addition to the Revenue Act of 1918 was explained by the report of the Ways and Means Committee of the House of Representatives, H. R. 767, 65th Congress, 2nd Session (p. 10) as follows:

> "The depletion provision of existing law does not grant an allowance for cost of development. In the case of mines, oil and gas wells, such an allowance seems only equitable and fair and the bill provides that a reasonable allowance in such cases be allowed for depreciation of improvements. * * *".

Thus it seems clear that Congress not only provided in this clause dealing with deductions in the case of natural resources that there should be a deduction allowed to the taxpayer on account of improvements, but its Committee specifically states that it was the intention that such allowance should be granted by way of depreciation. It follows that drilling costs which are part of the capital invested in the improvement were designedly included in the allowance for depreciation. This provision, in substantially identical language, has appeared in every Revenue Act since 1918, and it is specifically in the Revenue Act of 1926, as the quotation under Point I hereof shows.

III.

The Treasury Department regulation which requires that capitalized drilling costs must be returned through depletion allowance is arbitrary, discriminatory and in direct conflict with the mandate of the statute that there shall be a reasonable allowance for depreciation.

It is generally known that a large portion of the taxpayers comprising the oil industry charges drilling cost to expense as incurred and that another large portion charges drilling cost to capital account. Many cogent arguments can be adduced in support of either practice, but these are irrelevant as that question is not before this Court. So far as this petitioner is concerned, the facts show that it capitalized its drilling cost in accordance with a well recognized practice in the industry. The sole question involved is whether it must recover that cost through a depreciation allowance or through a depletion allowance.

Section 234 (a) (8) quoted above under Point I provides that there shall be a reasonable allowance for depletion and for depreciation of improvements. Since the Statute provides for a reasonable allowance for depletion and depreciation of improvements under regulations prescribed by the Department, it logically follows that the regulations so prescribed must likewise be reasonable. With full knowledge that both methods of dealing with drilling costs are used throughout the oil industry, the Treasury Department, in Regulations 69, Article 223, provides:

> "Such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the ex-

> ploration of the property, drilling of wells, building of pipe line, and development of the property, may at the option of the taxpayer be deducted as a development expense or charged to capital account *returnable through depletion.*" (Italics supplied.)

The Department construes this Regulation to mean that if a taxpayer capitalizes his drilling costs he must recover them through his depletion allowance. The practical effect of this is to grant deductions to taxpayers, as follows:

> (A) To taxpayers who capitalize drilling cost: 27½ per centum of gross income, this deduction including the amount of the drilling cost.*

> (B) To taxpayers charging off drilling cost: 27½ per centum of gross income, *plus the amount of the drilling cost.** (See Sec. 204 (c) (2) Revenue Act of 1926).

The discrimination which the Regulation creates is at once apparent from the above statement. Obviously, therefore, the Regulation as applied to the capitalization of drilling costs is unjust, arbitrary and discriminatory, and cannot, under any stretch of the imagination, be considered as "reasonable" as prescribed and required by the Statute. It is, therefore, in direct conflict with the mandate of the Statute so far as it requires the recovery of these capitalized costs through depletion. Return of capitalized drilling costs through depreciation, as prescribed by the Statute, would place both groups of taxpayers on a basis of near parity.

For the sake of clarity there is appended hereto an illustration of the computation of depletion allowance on an

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* In both cases the depletion allowance might exceed 27½ per centum of gross income if such greater deduction is necessary to restore actual capital invested.

assumed set of figures and of taxable net income on three bases, as follows:

1. With drilling cost charged to expense.
2. With drilling cost capitalized and returned through depreciation.
3. With drilling cost capitalized and returned through depletion.

IV.

Depletion and depreciation have a well defined judicial meaning in tax statutes and there is no reason for confusing their scope.

As early as 1917 this Court was called upon to decide whether the exhaustion of a mineral deposit could be classified as depreciation (*Von Baumbach* v. *Sargent Land Co.*, 242 U. S. 503. The case arose under the Corporation Excise Tax Act of 1909. That Statute provided for the deduction from income of "all losses actually sustained within the year * * * including a reasonable allowance for depreciation of property." (See opinion, p. 524.) At the bottom of page 524 and at the top of page 525 there is found a very lucid discussion of this problem and the conclusion of the Court is very succinctly summarized in these words: "But in no accurate sense can such exhaustion of the body of the ore be deemed depreciation." (p. 525). This principle has been further clarified and elucidated by this Court in the case of *United States* v. *Ludey*, 274 U. S. 295. There can, therefore, no longer be any question as to the clear distinction in the meaning of these two words, or any cause for confusion in their application to a taxing statute.

V.

Comment on Brief Submitted by the Respondent.

The foregoing matter represents, we submit, a conclusive case, but the brief filed by the respondent contains many cleverly worded statements which should not go unanswered.

Since the Government in its brief in this case simply refers to and relies upon the arguments set forth in its brief in the companion case, *United States* v. *Dakota-Montana Oil Company*, No. 434, October term, 1932, the references below are necessarily to the brief of the Government in the last named case.

A. The respondent argues that since drilling cost is not represented by tangible physical property, it is not properly subject to the depreciation allowance. This argument fails because the hole drilled in the ground is an integral part of a physical object, namely, a completed oil well. Furthermore, excavations for building foundations, bridge emplacements and tunnels, are not tangible physical properties taken alone, but manifestly, the complete foundations, the emplacements and the tunnels are physical properties and as such are proper subjects for depreciation allowance. The Department has never attempted to segregate the costs of excavations of these types from the cost of the completed structure in arriving at an allowance for depreciation. A simple example may illustrate the point here made. If a manufacturing organization excavated for an aqueduct to carry water from an available water supply to its plant and abandoned such excavation when partially or wholly completed, no one would argue that the excavation was subject

to depreciation, much less depletion. But if, after completing the excavation the organization placed therein a proper metal or other conduit for the purpose of carrying the water to the plant, no one would gainsay the right of such organization to depreciate the entire cost of the aqueduct, including the cost of the excavation, over its useful life. It is difficult to see any basis of distinction between such a case and the case of an oil well.

B. The respondent argues that because the drill hole has no useful life subsequent to the exhaustion of the mineral reserve, the drilling cannot be recovered through depreciation. This argument fails as the Statutes for many years have authorized an allowance for depreciation in the following terms:

> "* * * a reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence." (Sec. 214 (a) (8), Revenue Act of 1926 and corresponding sections of earlier Revenue Acts.)

Attention is directed to the fact that the allowance for depreciation specifically comprehends exhaustion.

C. The respondent argues that the regulations have received implied legislative approval. This is not the case, as the regulations, far from having received implied legislative approval, are in distinct conflict with the Statute and with the recorded intent of Congress as shown in Points I, II and III above.

D. The respondent argues that election to charge drilling costs to capital account as authorized by the regulations necessarily involved acceptance of the proviso in the regu-

lation that such drilling cost must be recovered through depletion. That taxpayers did not recognize the Department's attempt to arrogate to itself the right to alter and amend the Statue is clearly shown by the fact that there are three cases involving this question now pending before this Court, and by the fact that many additional cases involving this point are pending before the Bureau and will be settled in conformity with the decision of this Court.

E. The respondent argues that depreciation of drilling cost cannot be computed under the usual method of determining depreciation. This is not so. The practice of computing depreciation of casings, derricks and other physical property by means of the "unit of production method" is widely followed throughout the oil industry. The use of this method is not only accepted, but encouraged by the Bureau of Internal Revenue. See Treasury Department, Bureau of Internal Revenue, Bulletin "F" on Depreciation and Obsolescence (1920) page 30, where it states:

> "The capital sum to be replaced by allowance for depreciation should be charged off over the useful life of the property, either in equal instalments, this plan being generally known as the 'fixed percentage' method, or in accordance with any other recognized trade practice, such as apportionment over units of production."

Depreciation under this method is concurrent with and in direct proportion with recovery of the oil, and the depreciable investment in physical property is extinguished simultaneously with exhaustion of the deposit. Obviously no impropriety or inaccuracy would result from computing depreciation of drilling cost under the unit of production method.

VI.

Appendix B of Respondent's Brief.

Some reference should likewise be made to statements contained in Appendix B of the respondent's brief in *United States* v. *Dakota-Montana Oil Co.*, No. 434.

A. On pages 32 and 33, in attempting to draw a distinction between tangible and intangible costs, it is implied that physical equipment such as casing, derricks, etc., is properly subject to depreciation because it can be salvaged and transferred for use elsewhere, and that because the drill hole cannot be transferred for use elsewhre it is not subject to depreciation. This completely ignores the fact that the drill hole is an integral part of the oil well itself and is entirely inconsistent with the practice of the Bureau with respect to building foundations, dams, bridge emplacements, tunnels, aqueducts and similar facilities.

B. On pages 34 and 35 much is made of the fact that when the Revenue Act of 1918 was passed, section 234 (a) (9) provided for a reasonable allowance for depletion of oil and gas wells, the word "wells" being italicized throughout. There might have been some force to this argument had not these words been lifted bodily out of the context in which they appeared. Section 234 (a) (9) of the Revenue Act of 1918 provides: "In the case of mines, oil and gas wells, other natural deposits, and timber," there shall be a reasonable allowance for depletion and depreciation of improvements. The association of the words in the context shows clearly that Congress was referring to the natural deposits of oil and gas, not to the artificial wells built by man. Furthermore, when similar legislation was under

consideration when the Revenue Bill of 1926 was being proposed in Congress, the Senate Committee on Finance, Senate Report No. 52, 69th Congress, first session, pages 17 and 18, referring to the new provision relating to oil and gas wells, states:

> "The new sub-division provides that in the case of oil and gas wells discovered by the taxpayer on or after January 1, 1925, in an area not proven at the date of such discovery * * *."

The physical structure that comprises an oil or gas well which was here being considered is certainly not "discovered" by the taxpayer. It is quite obvious that Congress, in using the words "oil and gas wells" in Section 204, subdivision (c) of the Revenue Act of 1926, referred to the natural oil or gas deposit, as this history of the legislation plainly shows. Thus the much italicized use in this appendix of the word "wells" has very little force, when viewed in the light of the context of the Statute and the legislative history concerning it.

Conclusion.

The decision of the Board of Tax Appeals should be affirmed.

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Dated, New York, January , 1933.

Appendix.

ILLUSTRATION OF COMPUTATION OF TAXABLE INCOME

showing effect of decision in this case.

For this purpose it is assumed that, over the entire operating life of a property, the following results were obtained:

Lease cost	$ 100,000.00
Oil Sales	1,000,000.00
Production Expense, etc.	100,000.00
Well Cost:	
Equipment (Assumed no salvage value)	150,000.00
Intangible Drilling Cost	150,000.00

Taxable Income Under 1926 Act

	Drilling Cost Charged off	Drilling Cost Capitalized Restored through Depreciation	Drilling Cost Capitalized Restored through Depletion
Gross Income	$1,000,000.00	$1,000,000.00	$1,000,000.00
Deduct:			
Production Expense, etc.	$ 100,000.00	$ 100,000.00	$ 100,000.00
Drilling Cost Charged off	150,000.00	None–Capitalized	None–Capitalized
Depreciation:			
Of Equipment	150,000.00	150,000.00	150,000.00
Of Drilling Cost	None–Charged off	150,000.00	None–included with depletion
Total Deductions	$ 400,000.00	$ 400,000.00	$ 250,000.00
Net Income—before depletion	$ 600,000.00	$ 600,000.00	$ 750,000.00
27½% of Gross Income (See Sec. 204(c)(2) Revenue Act of 1926)	$ 275,000.00	$ 275,000.00	$ 275,000.00
50% of Net Income before depletion (See Sec. 204(c)(2) Revenue Act of 1926)	$ 300,000.00	$ 300,000.00	$ 375,000.00
Statutory Depletion allowance (See Sec. 204(c)(2) Revenue Act of 1926)	$ 275,000.00	$ 275,000.00	$ 275,000.00
The Statutory Depletion Allowance Comprises:			
Return of Lease Cost	$ 100,000.00	$ 100,000.00	$ 100,000.00
Return of Capitalized Drilling Cost	None–Charged off	None–Returned through depreciation	150,000.00
Allowance in excess of amount needed to return capital invested	$ 175,000.00	$ 175,000.00	$ 25,000.00
Total	$ 275,000.00	$ 275,000.00	$ 275,000.00
Net Income before Depletion—shown above	$ 600,000.00	$ 600,000.00	$ 750,000.00
Statutory Depletion Allowance	275,000.00	275,000.00	275,000.00
Taxable Net Income	$ 325,000.00	$ 325,000.00	$ 475,000.00

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CHARLES ELMORE

IN THE

Supreme Court of the United States

OCTOBER TERM, 1932

No. 448

PETROLEUM EXPLORATION, INC., *Petitioner,*

against

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF OF PETROLEUM RECLAMATION CORPORATION AS *AMICUS CURIAE*

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1. The cost of drilling oil wells is the cost of an "improvement" within the meaning of Section 234 (*a*)(8) and Section 215 (*a*)(2) of the Revenue Act of 1926 4

2. The "allowance for depletion" authorized by Section 204 (*c*)(2) is in lieu of the "allowance for depletion" authorized by Section 234 (*a*)(8) and in addition to the allowance "for depreciation of improvements" authorized by Section 234 (*a*)(8) 5

3. The Revenue Act requires that the cost of drilling oil wells be capitalized and recovered by allowances for depreciation of improvements and the Commissioner of Internal Revenue is without authority by regulation or otherwise to annex as a condition to the capitalization of such cost the requirement that it be recovered by allowances for depletion 7

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ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF OF PETROLEUM RECLAMATION CORPORATION AS *AMICUS CURIAE*

PRELIMINARY STATEMENT

Petroleum Reclamation Corporation and its affiliated corporations have now pending before the United States Board of Tax Appeals petitions for redetermination of deficiencies in income tax alleged to be due by the Com-

missioner of Internal Revenue upon the basis of the same interpretation of the provisions of the Revenue Acts with respect to allowances for depletion and depreciation as is relied upon by the Commissioner in the above-entitled case. Except as to the amounts involved, the facts are similar to those in the instant case. Petroleum Reclamation Corporation is therefore interested in the decision of this Court in the present case and seeks in this brief to set forth the reasons why it is believed that the decision of the United States Circuit Court of Appeals for the Fourth Circuit was in error and that the decision of the United States Board of Tax Appeals was correct.

OPINIONS BELOW

The opinion of the Board of Tax Appeals is reported in 23 B. T. A. 890. The opinion of the Circuit Court of Appeals is reported in 61 Fed. (2d), 273.

JURISDICTION, QUESTION PRESENTED, AND STATEMENT OF THE CASE

We refer to the brief for the Petitioner for statements as to the jurisdiction of this Court, the question presented, and the facts, all of which we adopt.

STATUTES AND REGULATIONS INVOLVED

In addition to the statutes and regulations cited in the brief for the petitioner there is also cited herein Section 215 (*a*)(*2*) of the Revenue Act of 1926, as follows:

"Sec. 215(*a*) General rule.—In computing net income no deductions shall in any case be allowed in respect of—* * *.

"(2) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate; * * *."

SUMMARY OF ARGUMENT

1. The cost of drilling oil wells is the cost of an "improvement" within the meaning of Section 234 (*a*)(8) and Section 215 (*a*)(2) of the Revenue Act of 1926.

2. The "allowance for depletion" authorized by Section 204 (*c*)(2) is in lieu of the "allowance for depletion" authorized by Section 234 (*a*)(8) and in addition to the allowance "for depreciation of improvements" authorized by Section 234 (*a*)(8).

3. The Revenue Act requires that the cost of drilling oil wells be capitalized and recovered by allowances for depreciation of improvements and the Commissioner of Internal Revenue is without authority by regulation or otherwise to annex as a condition to the capitalization of such cost the requirement that it be recovered by allowances for depletion.

ARGUMENT

1. The cost of drilling oil wells is the cost of an "improvement" within the meaning of Section 234 (*a*)(8) and Section 215 (*a*)(2) of the Revenue Act of 1926.

The Revenue Act contains no definition of "improvement". That the drilling of an oil well constitutes an improvement to the property in the ordinary and accepted sense of that term in common usage requires no argument. Here it is used in connection with natural resources. Its meaning in that connection has been the subject of judicial interpretation. The United States Bureau of Mines in its "Glossary of Mining and Mineral Industry" defines "improvement" in the language of the courts as follows:

> "*Improvement.* As used in the mining statutes, is an artificial change of the physical condition of the earth upon or reasonably near a mining claim as to evidence a design to discover mineral therein, or to facilitate its extraction. It must be reasonably permanent in character (*Frederick* v. *Klauser*, 32 Oregon 116)" (p. 357).

The Revenue Act does not purport to use the term in any special or limited sense. Clearly, therefore, the cost of drilling oil wells must for the purposes of Section 215 (*a*)(2) and Section 234 (*a*)(8) of the Revenue Act of 1926 be considered the cost of improvement to the property and treated accordingly.

2. The "allowance for depletion" authorized by Section 204 (c)(2) is in lieu of the "allowance for depletion" authorized by Section 234 (a)(8) and in addition to the allowance "for depreciation of improvements" authorized by Section 234 (a)(8).

Section 234 of the Revenue Act provides that deductions *shall* be allowed (1) "for depletion" (Section 234 (a)(8)) and (2) "for depreciation of improvements" (Section 234 (a)(8)) as well as (3) "for exhaustion, wear and tear of property used in the trade or business" (Section 234 (a)(7)). The alternative allowance provided by Section 204 (c)(2) is, on the contrary, deliberately confined to an allowance "for depletion". The word "depletion" appears three times in that subdivision. The "allowance for depletion" thereby granted is clearly to be substituted for the "allowance for depletion" made by the provisions of Section 234 (a)(8) and is not to be substituted for the allowance made by that subdivision "for depreciation of improvements".

If Congress had intended that the special allowance for depletion at the rate of 27½% of the gross income should be in lieu not only of the allowance for depletion made by Section 234 (a)(8) but also in lieu of the allowance made for depreciation of improvements by that section, it could have so provided in the simplest terms, and it is to be assumed that it would have done so.

The fact is that the coupling of the allowances for depletion and for depreciation of improvements in the same subdivision points clearly to the distinction between the allowances which it is intended to grant. It is too

clear to require argument that "depletion" does not include "depreciation of improvements". The distinction between the two terms is, moreover, clearly set forth in the opinion of this Court in *U. S.* v. *Ludey,* 274 U. S. 295, at pp. 300 and 302. "Depletion" relates peculiarly to natural resources, that is to the ore, the oil or the timber in its natural state. Any expenditures which may be incurred in developing such natural resources and which do not constitute an expense of operation to be deducted currently, constitute an improvement. Under this head naturally falls the cost of drilling wells.

It follows that the allowance for depletion made by Section 234 (*a*)(8) and Section 204 (*c*)(2) can not include any allowance for recovery of such costs. There is ample provision for the allowance of such recovery in the provisions of Section 234 (*a*)(8) as to depreciation of improvements and in the provisions of Section 234 (*a*)(7) as to exhaustion of property used in the trade or business.

Since drilling costs constitute improvements the treatment for which the respondent contends is tantamount to substituting the allowance for depletion under Section 204 (*c*) (2) for the allowance for depreciation of improvements as well as the allowance for depletion under Section 234 (*a*) (8). Except for the fact that the allowance for depletion and the allowance for depreciation of improvements are incorporated in the same subdivision of the Act it would be equally reasonable for the respondent to maintain that the allowance granted by Section 204 (*c*) (2) is to be substituted for the allowance for exhaustion, wear and tear granted by Section 234 (*a*) (7).

3. The Revenue Act requires that the cost of drilling oil wells be capitalized and recovered by allowances for depreciation of improvements and the Commissioner of Internal Revenue is without authority by regulation or otherwise to annex as a condition to the capitalization of such cost the requirement that it be recovered by allowances for depletion.

The cost of drilling oil wells is undoubtedly an expenditure incurred for the improvement and betterment of the property. Section 215 (*a*)(*2*) forbids the deduction of such expenditures currently and the Board of Tax Appeals has held in *Old Farmers Oil Company* v. *Commissioner* 12 B. T. A. 203 that the Revenue Act did not confer any authority upon the Commissioner to determine arbitrarily by regulation that a purely capital item was a business expense. It follows that the option which the Commissioner undertakes to grant in Article 223 of Regulations 69 is an option or privilege to deduct such items as an expense contrary to the provisions of Section 215 rather than an option or privilege to capitalize such items. Capitalization is the normal course; deduction as expense the exception. Since the favor extended appertains to the deduction as expense, the Commissioner might properly annex a condition to the exercise of the option to deduct expenditures currently but he may not in any event annex to the treatment of such items as capital expenditures (which is what the law requires) any condition such as the requirement that the recovery of the expenditure be had through depletion allowances. The regulation is not, therefore, in this aspect a proper exercise of the authority granted to the Commissioner

by Section 234 (*a*)(8) to prescribe rules and regulations for the determination of the allowance to be made pursuant to that subdivision. In this respect the United States Board of Tax Appeals in *A. T. Jergins Trust* v. *Com.*, 22 B. T. A. 551 said:

> "If this regulation is susceptible of the construction which has been placed upon it in this case, it is in conflict with the provisions of the statute, which allows improvements to be depreciated."

From the foregoing, it will be evident that the Circuit Court of Appeals for the Fourth Circuit erred in its decision in this case through misapprehension of the nature of the option which the Commissioner offers to taxpayers by the provisions of Article 223. In its decision the Court suggests that there was an "implied agreement to accept depletion when the taxpayer exercised the option to charge the expense to capital account" (p. 276) and holds that

> "* * * the regulations are reasonable, and, having been in force for a long time, they should be sustained, particularly where the taxpayer, as in this case, availed itself of the identical regulations to capitalize expenditures for intangibles, thus accepting the provision that such expenditures should be returned through allowances for depletion. The taxpayer cannot accept the benefits of the regulation and reject the accompanying obligation" (p. 277).

The Court failed to recognize that the capitalization of the expenditures in question was required by Section

215 (*a*)(2) and that their capitalization in the instant case was in conformity with the statute. The petitioner did not avail itself of a privilege granted by the Commissioner in exercising its right to comply with the requirements of Section 215 (*a*)(2) but refrained from availing itself of the privilege to deduct the expenditures currently. This being so, no agreement can be implied to accept depletion as the basis for recovery of the expenditures. The benefit which the regulation extends is the privilege to deduct expenditures currently. Any other interpretation of the regulation would impair its validity. This would be true irrespective of the practice to which the Commissioner may have adhered under the regulation, since the position that the option extended is an option to capitalize is untenable in the light of the provisions of Section 215 (*a*)(2). In order to support such a position it would be necessary for the respondent to argue that the Commissioner might by regulation change the statute. The true question would seem to be whether the Commissioner has the authority under Section 234 (*a*) (8) to extend the option to deduct such expenditures currently.

On page 38 of the brief for the Respondent in *The United States* v. *Dakota-Montana Oil Company*, now pending before this Court, (No. 434), it is demonstrated that the inevitable effect of restoring capitalized drilling cost through depletion is to impose upon the taxpayer who capitalizes drilling cost a greater tax than is imposed upon the taxpayer who charges off such cost as an expense. In other words, if, as we contend, the provisions of Section 215 (*a*)(2) require the capitalization of drilling cost and such cost may be deducted currently

only by reason of the extraordinary favor granted by the Commissioner as an option under Article 223, the effect of coupling with the option the requirement that capitalized drilling cost be recovered through depletion is unlawfully to discriminate between the taxpayer who avails himself of the privilege to deduct cost currently and the taxpayer who complies with the statute and capitalizes such cost. The authority to charge as an expense is derived from the regulation only. The authority to capitalize is derived from the statute and does not necessarily rest upon any regulation. May the taxpayer who follows the statutory requirement be taxed more than he who looks solely to the regulation for support? Surely, the Commissioner has no power thus to discriminate between taxpayers and by regulation to alter the amount of tax otherwise collectible.

CONCLUSION

It is submitted, therefore, that the decision of the United States Board of Tax Appeals was correct and that the Court below erred in reversing the Board. In order to sustain the decision of the Court below, it would be necessary to disregard the only reasonable interpretation of the word "improvement"; and to hold that the Commissioner might by regulation dispense with the provisions of Section 215 (*a*)(2) of the Act and annex to the exercise by a taxpayer of his right to comply with the requirements of that Section a condition which does violence to the terms "depletion" and "depreciation" as

defined by this Court. The decision of the Court below should be reversed.

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R. B. GOODELL,
Of Counsel.

January 18, 1933.

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CHARLES ELMORE CROPLEY
CLERK

IN THE

SUPREME COURT

OF THE

UNITED STATES.

October Term, 1932

Petroleum Exploration, Inc., *Petitioner,* *vs.* David Burnet, Commissioner of Internal Revenue,	No. 448.
United States, *Petitioner,* *vs.* Dakota-Montana Oil Company.	No. 434.

BRIEF OF MESSRS. THOMAS R. DEMPSEY AND A. CALDER MACKAY AS AMICI CURIAE,

Consent of counsel having been obtained.

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Consent of counsel having been obtained.

PRELIMINARY STATEMENT.

The question presented by this appeal is involved in numerous pending cases and may be briefly stated to be:

ARE CAPITALIZED EXPENDITURES FOR WAGES, FUEL, REPAIRS, HAULING, ET CETERA, MADE IN CONNECTION WITH THE DEVELOPMENT OF OIL PROPERTIES AND THE DRILLING OF OIL WELLS, SUBJECT TO AN ALLOWANCE FOR DEPRECIATION?

Under the Regulations of the Treasury Department taxpayers are permitted the option of capitalizing or charging to expenses such expenditures as are paid for wages, fuel, repairs, hauling, *et cetera*, in connection with the development of oil properties and the drilling of oil wells. The Regulations specifically provided that "If in exercising this option the taxpayer charges these incidental expenses to capital account, in so far as such expense is represented by physical property it may be taken into account in determining a reasonable allowance for depreciation." (Article 223, Regulations 62.)

The Commissioner has limited the application of this provision from the Regulation to tangible assets which go upon the property, such as lumber, cement, casing, tubing, *et cetera*, and excludes the costs expended: (1) for labor in making improvements, (2) in drilling the well, (3) for fuel used in such operation, (4) for hauling such materials, (5) for building pipe lines, (6) for roads, *et cetera*, and (7) for repairs.

It is believed that the Commissioner has erroneously construed his own Regulations, but if not, then we respectfully urge that the Regulations are in conflict with the provisions of the Statute which allow improvements to be depreciated.

The Board of Tax Appeals has in several cases held that taxpayers are entitled to the depreciation allowances claimed (*A. T. Jergins Trust v. Commissioner*, 22 B. T. A. 551; *Petroleum Exploration v. Commissioner*, 23 B. T. A. 890; *Albert W. Ziegler v. Commissioner*, 23 B. T. A. 1091; *P- M- K Petroleum Co. v. Commissioner*, 24 B. T. A. 360) while some of the courts have held otherwise.

This brief is filed in support of the decisions of the United States Board of Tax Appeals holding that taxpayers are, under the Statute, permitted to take the deductions claimed.

STATUTES AND REGULATIONS INVOLVED.

These are set forth in the appendix, *infra*, p. 17.

The Statutes have specifically allowed a deduction for depreciation, and in determining the cost of depreciable property it has been the consistent policy of taxpayers as well as the consistent policy of the Treasury Department to include in the cost thereof amounts expended for labor, fuel, transportation, *et cetera*. Indeed, it would never occur to the ordinary mind that these expenditures could be excluded. To exclude them would be to permit them to be deducted as ordinary expenses. The business world uniformly includes in the cost of buildings such expenditures as are made for labor, fuel, transportation, *et cetera*, in connection with the construction thereof. The Commissioner recognizes these principles insofar as they apply to improvements not related to oil properties.

The statutory provisions relating to an allowance for depreciation of improvements made and used in connection with oil properties are practically the same as the provisions allowing depreciation deductions generally; they are both intended to return to the taxpayer its actual cost of its property.

The section of the Statute under which the deductions for depreciation are claimed is Section 214 (a), which provides:

"In computing net income there shall be allowed as deductions:

"(9) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; * * *."

The mere fact that the allowance for depletion and depreciation are contained in the same section should be no reason for the Commissioner to allow depletion against expenditures made for the construction or acquisition of improvements or betterments. Both depreciation and depletion have a well understood meaning. This Honorable Court has stated that:

> "The depreciation charge permitted as a deduction from the gross income in determining the taxable income of a business for any year represents the reduction, during the year, of the capital assets through wear and tear of the plant used."

While

> "The depletion charge permitted as a deduction from the gross income in determining the taxable income of mines for any year represents the reduction in the mineral contents of the reserves from which the product is taken. * * *"
>
> *U. S. v. Ludey*, 274 U. S. 295, 300, 302.

We respectfully submit that oil wells and improvements connected therewith are a part of the plant used in production and not a part of the deposit; obviously, the reduction in value of an oil well due to wear and tear

through use is something apart from the reduction in value of the mineral reserve through removal of the product. The word "depletion" is derived from the Latin word "deplere" meaning to empty or exhaust, while the word "depreciation" is derived from the word "depretiare" meaning to lessen in value.

Congress recognized the difference in the passage of the foregoing Act. The legislative history clearly and convincingly proves that Congress not only recognized the difference between depletion and depreciation, but clearly intended that a depreciation allowance should be made for the exhaustion of improvements made and used in connection with the development of oil properties and the production of minerals therefrom. The section of the law controlling the case at bar was first inserted in the Revenue Act of 1918, and has repeatedly been re-enacted. The Report of the Ways and Means Committee of the House of Representatives (H. R. Report 767, 65th Congress 2nd Session) contained the following:

> "The depletion provision of the existing law does not grant an allowance for cost of development. In the case of mines, oil and gas wells such an allowance seems only equitable and fair and the bill provides that a reasonable allowance in such cases be allowed for *depreciation of improvements.*" (Italics ours.)

It is clear from the foregoing that Congress intended the cost of development to be returned to taxpayer through depreciation allowances and not through depletion allowances. It is believed that no clearer language could have been used to have expressed such an intention.

After the enactment of the Revenue Act of 1918 the Treasury Department promulgated its Regulation which in part (Art. 223) provided as follows:

> "Such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of wells, building of pipe lines, and development of the property may at the option of the taxpayer be deducted as a development expense or charged to the capital account returnable through depletion."

The Board of Tax Appeals (*Old Farmers Oil Company,* 12 B. T. A. 203) stated:

> "The Revenue Act of 1918 conferred no authority on the Commissioner to arbitrarily determine by regulation or otherwise that a purely capital item was a business expense."

The Commissioner acquiesced in the Board's decision (C. B. VII-2 p. 30). Irrespective of the option, however, the Regulation, had it contained no provision other than the excerpt above quoted, would have been invalid inasmuch as it ignored the provision of the law making an allowance for "depreciation of improvements." But the Regulation did not stop with the above quoted provision, it contained the following:

> "If in exercising this option the taxpayer charges these incidental expenses to capital account, in so far as such expense is represented by physical property it may be taken into account in determining a reasonable allowance for depreciation."

In the case before this Court the Commissioner has refused to follow the plain and ordinary meaning of the

Treasury Department's Regulation and is attempting to endow them with a meaning not susceptible thereunder. The true meaning of the Regulation is clear. When read in conjunction with the Statute the Regulation simply states that a depreciation allowance will be made with respect to all incidental expenses incurred in the exploration and development of an oil property provided that the expenditures are made in connection with improvements of a physical nature. The Commissioner, however, has taken the position that the term "physical property" as used in the Regulation has a very limited meaning.

The Statute allows a depreciation deduction with respect to improvements regardless of the nature, and the Regulation expressly provides for just such an allowance. However, the Commissioner is attempting to so construe the Regulation as to achieve a result which is not justified by the Statute or by the plain meaning of the Regulation.

It is respectfully submitted that the Court's approval of the Commissioner's construction of the Regulation would be tantamount to simply striking from the Statute the words "and for depreciation of improvements," for the very simple reason that the total cost of the improvements is not taken into consideration in determining the depreciation allowance. The Regulation, when read in conjunction with the section of the Statute under which it was promulgated, obviously requires that such of these expenses as are incurred in connection with the acquisition of physical property—improvements—must be returned through depreciation. All other of such expenses are re-

turnable through depletion. An illustration of the expenses returnable through depletion is the cost of a geological survey, resulting in no improvement of physical property, and which represents the cost of acquiring or locating the oil deposit.

The construction of the Regulation herein contended for brings it in harmony with the Statute while the Commissioner's construction thereof creates a direct conflict with the Statute. A construction of the Regulation that conforms to the requirements of the law is to be preferred to a construction resulting in a conflict. This would be so irrespective of how long the Regulation has been in effect or whether the Regulation has had legislative approval. It is not within the sphere of the Commissioner to alter or amend the law. He may not supply the omissions of Congress nor delete such provisions as are contrary to his conception of reasonableness or propriety. It is his duty to administer the law as he finds it.

Even though the Commissioner contends that the Regulation has had legislative approval, it cannot be successfully contended that his interpretation of the Regulation has been clothed with equal dignity. If Congress placed its approval upon the Regulation by subsequent reenactments, it must be presumed to have interpreted it according to the plain meaning of its terms and in the light of the law itself. Certainly Congress cannot be charged with an interpretation by the Commissioner of the Treasury Department's Regulation which is contrary to its plain terms. Prior to the passage of the 1932 Act the Board of Tax Appeals had, in the four cases heretofore cited, determined that the Commissioner's in-

terpretation was erroneous; there had been no decision prior to the passage of the 1932 Act which upheld the Commissioner's interpretation. If the Regulation has received approval by Congress it has been the approval of the interpretation herein contended for and as approved by the United States Board of Tax Appeals.

We believe the United States Board of Tax Appeals was right when, in the Jergins case, 22 B. T. A. 551, it stated:

> "The precise wording of the statute indicates clearly that Congress had in mind the distinction between the exhaustion of the natural resources and the recovery of the capital invested in the improvements necessary to work the property. It cannot be seriously contended that the exhaustion of petitioner's investment in preparing for and in drilling its wells constitutes any part of the exhaustion of its oil reserves. * * *."
>
> "* * * The cost of labor for erecting the derrick or drilling the well, the fuel used in such operation, the cost of hauling such materials are all 'represented by physical property.'"

It is a significant fact that the Commissioner before the United States Board of Tax Appeals in the Jergins case recognized the legality of this statement, which is evidenced by the following excerpt from the Board's opinion:

> "The Commissioner in his brief recognizes that such is the case and now urges that we sustain his action upon the ground that the stipulated facts are insufficient to show what part of the amounts disallowed were represented by physical property. * * *"

However, the Commissioner in his brief, at page 36, before the United States Circuit Court of Appeals for the 9th Circuit in the case of *A. T. Jergins Trust v. Commissioner of Internal Revenue*, refused this recognition and gave his interpretation of the article in the following language:

> "These articles of the regulations undertake to distinguish between expenditures for physical property subject to depreciation and expenses incurred in exploration, drilling, and development, which do not result in any tangible physical property apart from the land itself. There is an appropriate factual basis for this classification. 'Physical property' as used in the regulations, as shown by the classes of property specifically mentioned as illustrations, refers to articles of property which have measurable service lives depending upon their own inherent qualities and the extent of their use in the enterprise. These factors determine the rates at which such property is consumed. The amount of its annual depreciation is ascertainable under the general principles and by the usual methods for determining allowances for depreciable property used up in business. On the other hand, money spent in exploring for oil, for development (such, for example, as clearing the surface of the land), the digging of the hole in the ground through which the oil is extracted, does not result in any article of property apart from the land. It does result in changes in the conformation of the land, and may be regarded as providing facilities for access to and extraction of the mineral, but there is no gradual wearing out or using up of such facilities. They are, of course, no longer useful when all of the mineral has been extracted, but their usefulness is associated with and measured by the quantity of the mineral.

> Such facilities are similar to shafts, tunnels, slopes, stripping, etc., in the case of a coal mine which are made while the mine is in the development stage, the cost of which is likewise recoverable through depletion allowances. Article 222, Regulations 62."

The above construction of the Regulation completely ignores the provision of the Statute permitting a depreciation deduction with respect to *improvements*. It may be assumed that certain "improvements" such as grading, roads and the drill hole "do not result in any tangible physical property apart from the land itself." It is equally obvious that such improvements have "service lives" *not* depending upon their own inherent "qualities." Their service lives depend solely upon the life of the mineral reserve itself. They are useful in an oil property just so long as it produces oil. After the property is exhausted they are utterly worthless for the purpose for which originally constructed. It may even be assumed that with reasonable repair, the cost of which is deductible as an expense, such improvements would last forever. But Congress, in providing for a depreciation deduction with respect to improvements, had in mind that any improvement put upon a property for the purpose of development and operation has a useful life no longer in any case than the life of the deposit itself. This was the obvious reason for permitting the deduction for depreciation of improvements. The drill hole of an oil well is a part of the well itself. In addition to the drill hole a completed oil well has a large number of other parts, for instance, casing which keeps the hole from caving in, the derrick, boiler plant, engines, pumps, etc. All these things are necessary to make an oil well. An oil well is an

improvement. Under the Commissioner's interpretation the drill hole is something separate and apart from the oil well itself and is not an "improvement" for the reason that the drilling of the hole does not "result in any tangible physical property apart from the land itself."

As above indicated, it may be assumed *arguendo* that the drill hole by itself is not an improvement but when casing has been installed in it and other things necessary to make a completed oil well, then the hole constitutes a part of an improvement. The cost of drilling the hole is, therefore, a part of the cost of the completed improvement.

To say that the parts of an oil well other than the drill hole "have measurable service lives depending upon their own inherent qualities" is totally beside the point. Aside from ordinary repairs necessary in any improvement the several parts of an oil well will last, stated as a general rule, until the oil deposit is exhausted. Except in very unusual cases the casing in the hole will last as long as oil can be produced through it. When the deposit is exhausted some of the casing may be pulled out of the hole and salvaged, but very few oil men ever use it in another oil well. The fact that the salvage may be recovered from an oil well does not require any changes in the usual computation of depreciation thereon because salvage is usually recovered from every fixture. For instance, when buildings are torn down salvage is recovered but the Regulations generally provide that in making computation of the capital returnable through depreciation allowance must be made for salvage.

The Commissioner admits that improvements "which do not result in any tangible physical property apart from

the land itself" are "no longer useful when all the mineral has been extracted" but he further contends "their usefulness is associated with and measured by the quantity of the mineral." That their usefulness must be measured by the quantity of the mineral is, of course, undeniable. This is likewise true with respect to certain items which the Commissioner terms physical property in his construction of the Regulation. The depreciation on the cost of an oil well other than the drill hole is determined by the Commissioner by reference to production. By this method the cost of the well except the cost of the drill hole is depreciated over the life of the mineral deposit. This is in recognition of the fact that "their usefulness is associated with and measured by the quantity of the mineral." From these considerations it is apparent that the Commissioner's construction of his Regulation is not only totally lacking in "an appropriate factual basis for this classification" but wholly disregards the Act under which the Regulation was promulgated.

It is significant that Congress in framing Sec. 234(a)(8) of the Revenue Act of 1924 and corresponding sections in the Revenue Acts, used the word "improvements" and in Section 234(a)(7) and corresponding sections of other Revenue Acts the term "property" was used. A road, a sump hole, a cellar or a drill hole is not "property" but is an "improvement" or part of an improvement. The cost of each is, therefore, subject to depreciation if it has a measurable service life.

The United States Board of Tax Appeals in the Jergins case aptly stated that the "amounts expended in development and drilling operations convey to us the

impression of expenditures for improvement of the property upon which the Statute permits the taxpayer to deduct depreciation." We, therefore, respectfully submit that taxpayers are entitled, under the Statute, to depreciation deductions based on the full cost of their improvements.

Respectfully submitted,

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APPENDIX.

REVENUE ACT OF 1926:

"Sec. 234. (a) In computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

* * * * * * * * *

"(7) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence;

"(8) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee;"

"Sec. 204(c) (2). In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph."

TREASURY REGULATIONS 69 provide:

"Art. 221. Depletion in the Case of Oil and Gas Wells.—Under section 204(c) (2), in the case of oil and gas wells, a taxpayer may deduct for depletion an amount

equal to 27½ per cent of the gross income from the property during the taxable year, but such deduction shall not exceed 50 per cent of the net income of the taxpayer (computed without allowance for depletion) from the property. In no case shall the deduction computed under this paragraph be less than it would be if computed upon the basis of the cost of the property or its value at the basic date, as the case may be. In general, 'the property,' as the term is used in section 204(c) (2) and this article, refers to the separate tracts or leases of the taxpayer."

"Art. 223. Charges to Capital and to Expense in the Case of Oil and Gas Wells.—Such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of wells, building of pipe lines, and development of the property may at the option of the taxpayer be deducted as a development expense or charged to capital account returnable through depletion. If in exercising this option the taxpayer charges these incidental expenses to capital account, in so far as such expense is represented by physical property it may be taken into account in determining a reasonable allowance for depreciation. * * *."

"Art. 225. Depreciation of Improvements in the Case of Oil and Gas Wells.—Both owners and lessees operating oil and/or gas properties will, in addition to and apart from the deduction allowable for depletion as hereinbefore provided, be permitted to deduct a reasonable allowance for depreciation of physical property, such as machinery, tools, equipment, pipes, etc., so far as not in conflict with the option exercised by the taxpayer under article 223. The amount deductible on this account shall be such an amount based upon its cost or other basis equitably dis-

tributed over its useful life as will bring such property to its true salvage value when no longer useful for the purpose for which such property was acquired. Accordingly, where it can be shown to the satisfaction of the Commissioner that the reasonable expectation of the economic life of the oil or gas deposit with which the property is connected is shorter than the normal useful life of the physical property, the amount annually deductible for depreciation on such property may be based upon the length of life of the deposit. (See articles 161-170.)"

Due service of the within brief is hereby acknowledged this.....day of February, A. D. 1933.

_____

Attorneys for Petitioner.

_____

Attorneys for Respondent.

SUPREME COURT OF THE UNITED STATES.

No. 448.—October Term, 1932.

Petroleum Exploration, Petitioner, *vs.* David Burnet, Commissioner of Internal Revenue.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Fourth Circuit.

[March 13, 1933.]

Mr. Justice Stone delivered the opinion of the Court.

Petitioner, a Maine corporation, in making its tax returns of income derived from the operation of oil wells in the years 1925, 1926, and 1927, claimed a deduction from gross income of a depreciation allowance on account of the capitalized costs of drilling the oil wells. The Commissioner refused to allow the deductions and assessed a corresponding deficiency against the taxpayer. On appeal the Board of Tax Appeals held that the deductions should have been allowed. 23 B. T. A. 890. On petition for review the Court of Appeals for the Fourth Circuit reversed the order of the Board. 61 F. (2d) 273. The court held that the deductions claimed were included in the depletion allowance fixed by § 234 (a) (8) of the Revenue Act of 1926 at 27½% of petitioner's gross income for the years in question, and could not be allowed as depreciation of improvements. This Court granted certiorari to resolve a conflict of the decision below with that of the Court of Claims in *Dakota-Montana Oil Co.* v. *United States*, 59 F. (2d) 853. For reasons stated in No. 434, *United States* v. *Dakota-Montana Oil Co.*, decided this day, the Commissioner rightly refused to allow the deductions claimed and the judgment below is

Affirmed.

A true copy.

Test:

Clerk, Supreme Court, U. S.